Graduate School, USDA

Ideas Confront Reality: An Analysis of Critical Issues in the Reagan Era

Critical Issues and Decisions, Series V

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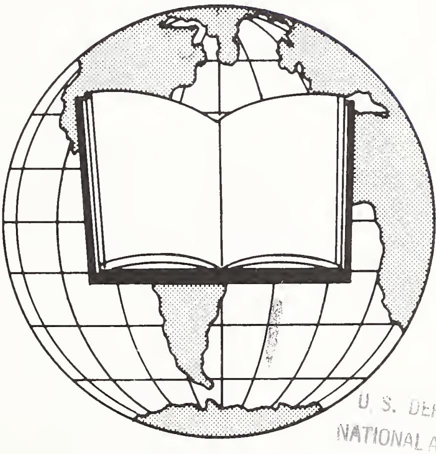

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PREFACE

The Graduate School, USDA, is a dynamic, nonprofit government organization whose mission is to provide continuing education to government employees. Although originally founded to give post-graduate education to agricultural research scientists, the Graduate School has since broadened its programs to serve the government overall. Since 1921, the School has served hundreds of thousands of government workers, their agencies and ultimately the public served by government. The School takes pride in its relevance to rapidly changing times.

For management and executive leadership, relevance has a broad meaning. Executives must make decisions based on theories—underlying assumptions about how and why things operate the way they do. Especially in the 1980s, the analysis of economic theory is fundamental for executive development.

This volume, *Ideas Confront Reality: An Analysis of Critical Issues in the Reagan Era*, is an outgrowth of the Critical Issues and Decisions Series, which dates back to 1961. Twenty years ago the Graduate School launched a seminar series in which select leading thinkers focused on timeless issues of current importance. Their purpose was to search for truths that might be applied to contemporary problems. The same purpose animates the current series. The principal issues in these papers deal with economic theory, foreign policy, and the Constitution. These are timeless subjects with topical relevance. The seminar series provided an opportunity for a group of federal government executives to hear these ideas, read about them, and discuss them with the five guest resource persons. Their comments are included at the close of each chapter.

I hope this volume has captured the essence of those ideas and the dialectical flavor of that dialogue.

As in any effort of this type, there are many who make significant contributions. Dr. John Holden, Director Emeritus of the Graduate School, deserves credit for providing overall leadership to the series. Dr. Clark Edwards, of the Department of Agriculture, provided able direction to the discussions and to program planning. Dr. Donald J. Senese, of the Department of Education, edited this publication and

provided his valuable advice during the entire process. In addition to the above, Dr. Leonard Oliver, of the National Endowment for the Humanities; Chuck Heatherly, of The Heritage Foundation; and L. Scott Varner, of the Graduate School Staff, helped the program. Terry Wells coordinated the operations of the seminar, and Dolores McDonagh provided administrative assistance.

Our deepest appreciation goes to the resource people who gave of their time and energy to prepare papers for this publication and to discuss them with seminar participants. Our thanks also to those seminar participants for their enthusiasm and insights.

All books published by the Graduate School Press are reviewed by the Graduate School's Committee on Publications, under the leadership of Peter A. Smith. Other members of the Committee are Theodora E. Carlson, James A. Horton, Hubert W. Kelley, Jr., Robert J. McKendry, and Julie N. Walker. Norma Harwood, Margaret Brown and Linda Coyle of the Graduate School staff provided invaluable help in preparing and printing the manuscript.

Reflecting upon his experience in the 1962 Critical Issues Seminar, participant Rollien Wells wrote in part:

> "A single candle cannot light a hall,
> But, multiplied, it pushes back the night.
> Don't stop! This course can open wide the eyes,
> Supply a thousand men with clearer visions
> To meet the issues of the world with wise
> Decisions."

As the Graduate School celebrates its 60th year of service to government, we hope that this effort, as well as others, may help government to deal better with the increasingly complex problems facing the U.S. and the world.

Edmund N. Fulker
Director, Graduate School

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DONALD J. SENESE

Formerly Senior Research Associate with the Republican Study Committee, U.S. House of Representatives, Dr. Senese is now Assistant Secretary Designate for the Office of Educational Research and Improvement, U.S. Department of Education.

From left to right: Editor Dr. Donald J. Senese, Dr. Edward N. Fulker, Director of the Graduate School, USDA and Dr. John B. Holden, Seminar Coordinator and former Director of the Graduate School, USDA confering on the seminar.

INTRODUCTION

One of the greatest challenges of governing is translating ideas into practice—into the day-to-day operation of government. The USDA Graduate School Program chronicled in these pages attempted in a modest way to do just that by bringing together government policymakers and economists who address with authority the wisdom of supply-side economics. The seminar was particularly timely because in 1981 the United States is entering a new decade, and a national election has brought to power a Republican President (by a landslide), Republican control of the U.S. Senate for the first time in a quarter of a century, and significant Republican gains in the U.S. House of Representatives. Viewing the fundamental differences in philosophy which separated the Democrat and Republican presidential nominees in the 1980 contest, many political prognosticators have heralded the 1980 election as the most significant shift in U.S. economic policy since the election of FDR to the presidency in 1932.

The problems the United States faces at the beginning of the 1980s are serious: double digit inflation, large unemployment, high interest rates, growing federal deficits, an expanding money supply, a low level of productivity, increased foreign competition that is worsening domestic economic conditions, and crises in various world "hot spots" that threaten world peace (e.g., the Persian Gulf, Latin America, Afghanistan, Poland, Southeast Asia). Can the Reagan Administration turn the tide? Can new programs and policies solve or at least ameliorate some of our more serious economic problems? Can the United States achieve increased productivity, expanded employment, and lower inflation as it moves toward a stable economic policy? Can the United States gain the initiative in the world politics building its strength while maintaining peace? The answers will come not only from the elected officials but also, at least in part, from policymakers at all administrative levels of the Executive branch.

Dr. Donald J. Senese, Assistant Secretary Designate for the Office of Educational Research and Improvement, U.S. Department of Education.

The economic program of the Reagan presidency has captured so much attention because it attempts to substitute a philosophy of economic growth (or supply-side economics) for the long-dominant New Deal-Great Society-Keynesian approach which relied heavily on the federal government to control the nation's economy. The Reagan Administration offers a comprehensive economic shift in emphasis away from the public towards the private sector of the economy by the following: (1) a substantial reduction in federal expenditures of at least $40 billion in the Fiscal Year 82 budget and a downward shift in federal spending growth rates from 16 to 7 percent, to move toward a balanced federal budget, (2) a 3-year, 30 percent reduction in all individual income tax rates designed to restore incentives and renew economic growth, (3) a reduction in federal regulation, particularly those regulations which are excessively burdensome to the national economy and those affecting the key industrial sector, and (4) a movement toward a consistent and stable monetary policy. The philosophy motivating these goals found clear expression in the message sent to Congress by President Reagan:

> *This plan for national recovery represents a substantial break with past policy. The new policy is based on the premise that the people who make up the economy—workers, managers, savers, investors, buyers, and sellers—do not need the government to make reasoned and intelligent decisions about how best to organize and run their own lives. They continually adapt to best fit the current environment. The most appropriate role for government economic policy is to provide a stable and unfettered environment in which private individuals can confidently plan and make appropriate decisions. The new recovery plan is designed to bring all aspects of government policy a greater sense of purpose and consistency.*
>
> *Central to the new policy is the view that expectations play an important role in determining economic activity, inflation, and interest rates. Decisions to work, save, spend and invest depend crucially on expectations regarding future government policies. Establishing an environment which ensures efficient and stable incentives for work, saving, and investment now and in the future is the cornerstone of the recovery plan.*[1]

The "past policy" from which this philosophy departs is that advocated by John Maynard Keynes in ***The General Theory of Employment, Interest and Money.*** Keynes believed that the central government, by a policy of stimulus and restraint, could smooth out the ups and downs of the economy and that government activity was needed to keep the economy operating at a level of prosperity for all. Despite Keynes' erudition the performance did not live up to the promise. In fact, government policies are not simply a choice between high inflation (and low unemployment) on one hand and low inflation (and high unemployment) on the other. The late 1960s and 1970s brought ***both*** high inflation ***and*** high unemployment in a stagnating economy. Economists James Gwartney and Richard Stroup observe that just as Adam Smith set the stage for the free trade environment in the nineteenth century, so did the Keynesian macroeconomic thinking establish "the foundation for the policies which provided us with the inflation, unemployment, and stagnation of the 1970s."[2]

Before the Reagan Administration embraced supply-side economics, the foundation had been established by such luminaries as Professor Arthur Laffer of the University of California, journalist Jude Wanniski, and Congressman Jack Kemp of New York. According to their approach, a tax cut would do more than just cut taxes and reduce government revenue; a tax cut could also be used to influence certain desirable behavior. The Laffer Curve posits two rates that produce the same revenues. The task of political leaders, according to the theory, is to find that rate which maximizes income growth while allowing the distribution of income consistent with welfare.

The Laffer Curve has political as well as economic consequences. Wanniski believes that the Republican Party forgot this economic lesson (1) when it supported the the Smoot-Hawley Tariff in 1930, thus aggravating the severity of the Great Depression, and (2) later when President Eisenhower in 1953 opposed H.R. 1, which would have resulted in a 20 percent across the board tax cut in 1953. Thus, Wanniski reasons, the way for the Republican Party to grow is through embracing the Laffer Curve with a commitment to economic growth, not redistribution, and this political road will lead to a Republican renaissance.[3] Congressman Jack Kemp views the challenge of the 1980s as one of exciting the "vital qualities of human ingenuity and pressing ahead to gain the necessary tax and monetary reforms which will premit growth."[4] And political columnist David S. Broder has described the Reagan-Laffer-Wanniski-Kemp program as essentially a "new doctrine of growth and incentives, keyed to lowered tax rates and less regulation."[5]

In addition to the tax policy, the Reagan Administration program will involve government executives in another new role—the shift of the focus on certain current programs from the federal government to administration by the states via the "block grant" program. While making no claims that federal administration is automatically less efficient than state administration, the tacit thesis behind the program is that greater decision-making powers should be located close to the people who will be affected by the program.

The shift in decision-making power to state and local governments is an outgrowth of the ongoing debate in American society over the proper role of government. In writing an introduction to a book on the problems and recommended policies for the next decade, Hoover Institution scholars Peter Duignan and Alvin Rabushka note that the American political climate is turning away from the orthodoxies of the 1960s and 1970s (dramatic growth in legislation, government regulation, public sector spending, and bold new policy initiatives in a host of social areas), while government in the 1980s is likely to remain more circumspect and less likely to spend beyond its fiscal means than in the past two decades.[6] Professor James Q. Wilson has documented the harmful side effects of overregulation.[7] Milton and Rose Friedman have espoused a number of new proposals promoting private sector involvement over public sector intervention.[8] And two college economics professors, James T. Bennett and Manuel H. Johnson, advocate a greater reliance on the private rather than public sector to produce goods and services more efficiently.[9]

The Reagan Administration's foreign policy will enhance the role of the Defense Department and give a different orientation to the State Department. The outlines of new policies are clearly visible: a harder line against Soviet aggression; a renewal of ties with U.S. allies throughout the world; renewed efforts against internal terrorism; a shift in the human rights policy which will balance it with national security considerations; and especially a stronger national defense establishment as a preparation for any renewed arms limitation talks. Government executives will be dealing with these new policies at the Defense and State Departments, the Central Intelligence Agency, the Peace Corps, and U.S. embassies throughout the world. A post-Vietnam syndrome left the United States meek and timid in world affairs. The resolution of the Iranian hostage crisis, criticism of Soviet aggression (e.g., Afghanistan) and a renewed interest in combating terrorism and revolution in Latin America reflect certain new directions already in foreign policy. During the 1960s and 1970s there was a hostility toward the U.S. role in world affairs from the intellectual class and the media. A shift has taken place in public perceptions of the U.S. role—a shift which became evident during the 1980 presidential campaign. And a perceptive observer such as *Commentary* editor Norman Podhoretz views the shift as one away from a cult of appeasement to a "new nationalism," represented by a stronger defense establishment and a growing concern with the increasing strength and hostile actions of nations like the Soviet Union.[10]

Will these ideas in domestic and foreign policies be incorporated into workable programs for the 1980s? Only the actual events of the next few years will be able to answer that question decisively. According to Peter Steinfels, intellectuals serve as advisors to officeholders and political candidates, write speeches, propose programs, draft legislation, and serve on special commissions. The mass media amplify ideas for a wider audience. Steinfels assigns two major tasks to these intellectuals: (1) they lend to officeholders their expertise in particular fields of public policy and work out the details of political measures, and (2) as the traffickers in society's symbols and values, they legitimize these ideas and policies. While noting that politics is the art of the possible, Steinfels warns against underestimating the crucial role that thinkers, writers, and artists have in defining for practical men just what is possible.[11]

Dr. Russell Kirk, whose 1953 work *The Conservative Mind* provides a history of conservative thought, notes that in the United States and Britain it takes at least three decades for a body of convictions to be expressed, discussed, and incorporated into public policy. He dates the American intellectual renewal of conservative ideas to about 1950.[12] Herbert Stein notes that for years "big tax cuts, balanced budgets and indiscriminate references to getting government off our backs" have been a platform to get into office, but now conservatives will "have to discover what they want to stand on."[13]

The speakers in the "Critical Issues and Decisions for Government Executives" series represent a broad spectrum of expertise on public policy. The nature of supply-side economics has been described by two speakers: Dr. Charles T. Schultz and Dr. Don Paarlberg. Examining detente and alternatives to it constitutes the focus of the address by Dr. Robert L. Pfaltzgraff, Jr. The broader policy questions concerning our constitutional government are explored by Dr. Robert A. Goldwin. And finally an attempt to take a long-range look into the 1980s and the future beyond is provided by Dr. William Branson. Over 25 senior level government officials attended each session, asked questions, participated in the discussions, and then, breaking into separate teams, submitted commentary on each topic. That commentary is included in this book. A list of the participants, who brought a wide range of views and experience to this process, is also included. Hopefully, these senior-level officials will take the information and the spirit of the program back to their agencies.

This seminar sought to allow the participants to identify better the key social, economic, and political forces and problems, evaluate the implications of these forces and problems for governmental and private sector policy decisions, develop other strategies for dealing with the critical issues discussed in this seminar, and describe the complex interrelationships of the issues and thereby the difficulty of attempting to resolve them independently of one another.

The USDA Graduate School has conducted the "Critical Issues and Decisions" course previously and issued collections of these proceedings in 1961, 1963, 1964, and 1967. This volume marks the twentieth anniversary of the series.

As we continue to observe and reflect on the Reagan Administration, it is clear that this Administration has an operative Conservative philosophy and agenda which greatly influences its policies. President Reagan has made this clear in numerous statements, but particularly clear in his address to a gathering of his long-time supporters at the

Conservative Political Action Conference on March 20, 1981, at the Mayflower Hotel in Washington, D.C. The President related:

> *For whatever history does finally say about our cause, it must say: The conservative movement in twentieth century America held fast through hard and difficult years to its vision of the truth.*
>
> *And history must also say that our victory, when it was achieved, was not so much a victory of politics as it was a victory of ideas, not so much a victory for any one man or party as it was a victory for a set of principles—principles that were protected and nourished by a few unselfish Americans through many grim and heartbreaking defeats.*
>
> . . . . . .
>
> *We have come to a turning point. We have a decision to make. Will we continue with yesterday's agenda and yesterday's failures, or will we assert our ideals and our standards, reaffirm our faith, and renew our purpose? This is a time for choosing.*[14]

Having abandoned "yesterday's agenda and yesterday's failures," will the Reagan conservatives successfully translate their ideas into realistic policies that will solve the problems to meet the challenges of the next decade? This book attempts to provide some guidelines in answering that question.

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[1] Henry Steele Commager, *The Empire of Reason: How Europe Imagined and America Realized the Enlightenment*, Garden City, New York: Anchor Press/Doubleday, 1978, p. XI.

[2] James Gwartney and Richard Stroup, "The Creation of Economic Chaos: Inflation, Unemployment, and the Keynesian Revolution," *The Intercollegiate Review*, 16 (Fall/Winter, 1980), No. 1, p. 3. An article which refutes the Keynesian interpretation of the Great Depression as a breakdown of the old economic order built on free markets and competition can be found in Hans Sennholz's "The Great Depression: State-Caused Chaos,"

Perspectives on Public Policy by the Council for a Competitive Economy, reprinted from the April 1975 issue of *The Freeman*, published by the Foundation for Economic Education.

[3]Jude Wanniski, *The Way the World Works*, New York: Simon and Schuster, 1978, pp. XII, 301. Irving Kristol, a leading neoconservative, has called the book the "best economic primer since Adam Smith."

[4]Jack Kemp, *An American Renaissance: A Strategy for the 1980s*, New York: Harper and Row, 1979, p. 194.

[5]David S. Broder, *Changing of the Guard: Power and Leadership in America*, New York: Simon and Schuster, 1980, p. 171. The supply-side approach is put in historic perspective by Tom Bethell, "The Death of Keynes: Supply-Side Economics," *National Review XII* (December 30, 1980), No. 26, pp. 1560-1566.

[6]Peter Duignan and Alvin Rabushka, *The United States in the 1980s*, Stanford, California: Hoover Institution, Stanford University, 1980, pp. XIX, XXVIII.

[7]James Q. Wilson (Editor), *The Politics of Regulation*, New York: Basic Books Inc., 1980.

[8]Milton and Rose Friedman, *Free to Choose: A Personal Statement*, New York: Harcourt Brace and Jovanovich, 1980.

[9]James T. Bennett and Manuel H. Johnson, *Better Government at Half the Price: Private Production of Public Services*, Ottawa, Illinois: Caroline House Publishers, Inc., 1981.

[10]Norman Podhoretz, *The Present Danger*, New York: Simon and Schuster, 1980, pp. 86-89.

[11]Peter Steinfels, *The Neoconservatives: The Men Who Are Changing America's Politics*, New York: Simon and Schuster, 1979, pp. 6-7. Steinfels presents some examples of how the legitimating process which creates an intellectual atmosphere occurs: "Daniel Bell writes a book and a syndicated columnist appropriates its theses for his Bicentennial musings. Irving Kristol derides a 'new class' of liberal intellectuals for its snobbish attitude

toward a business civilization, and Mobil Oil incorporates this idea in its public relations advertising. Alexander Bickel, Yale University Law School professor, writes an article on the failure of school integration in the North, and a White House aide refers to it twice in a 1970 memo to Nixon arguing that 'the second era of Re-Construction is over; the ship of integration is going down; it is not our ship. . .and we ought not to be aboard.' " *Ibid.*, p. 6.

[12] Russell Kirk, *The Conservative Movement: Then and Now*, Washington, DC: The Heritage Foundation, 1980, pp. 2, 10.

[13] Herbert Stein, "Economic Policy, Conservatively Speaking," *Public Opinion*, 4 (February/March 1981), No. 1, pp. 2-3.

[14] "A Tribute to the Conservative Movement," *National Review* XXXIII (April 17, 1981), No. 7, pp. 402-403.

CHARLES L. SCHULTZE

Senior Fellow at the Brookings Institution. During President Carter's term, Dr. Schultze served as Chairman of the Council of Economic Advisors. He has also been Director of the U.S. Bureau of the Budget and taught economics at the University of Maryland and the University of Indiana. Mr. Schultze is the author of many articles on economics and politics.

From left to right: Albert J. Planagan, Director, Commerce Action Groups for the Near East, Department of Commerce; Neil B. Christianson, General Engineer (Logistics Specialist), U.S. Air Force; Dr. Clare I. Harris, Acting Associate Director, S&E, USDA/SEA; and Edward I. Reinsel, Agricultural Economist, USDA/ESS. *Not in picture:* Robert F. Fagin, Director, Office of OMI, Department of Housing and Urban Development.

THE INTEGRATION OF DEMAND AND SUPPLY SIDE POLICIES*

Charles L. Schultze

Economic policy must place greater emphasis on supply-oriented measures during the decade of the 1980s for a number of reasons. First, an increase in the growth of aggregate supply, and especially in the growth of productivity, can raise the growth of output and employment that is consistent with a steady reduction in inflation. Second, reducing this country's vulnerability to higher oil import bills will require a substantially increased investment in alternative energy sources over the next 10 years. Finally, even if inflation were not a problem, a speed-up in the lagging rate of productivity growth would be essential to maintain the historic advance in our standard of living.

The remainder of the chapter summarizes what has been happening to productivity in the United States and briefly examines some of the reasons why the rate of productivity growth has declined. It also examines the need to increase the share of national resources allocated to capital formation and the Administration's response to that need. Finally, it discusses the relationship between demand- and supply-side policies and suggests how they must be integrated.

Advances in productivity are the foundation of advances in our standard of living. Increases in output per worker lead to increases in real income. Healthy increases in productivity can free the funds needed to improve the conditions of disadvantaged groups while lessening the need for sacrifice elsewhere. Thus, when productivity growth declines, these other advances are delayed. But expectations of a rising living standard persist. They perpetuate demands for real income gains which can no longer be met and which lead to inflationary increases in wages and to growth in government spending.

Since the mid-1970s, the growth rate of labor productivity has been declining from its post-World War II highs. In recent years

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**Excerpts from the Economic Report of the President, 1981* the decline has been so marked as to pose a major challenge to public policy. Because declining productivity growth brings with it prospects for slower improvement in our standard of living and contributes to inflation, a program to stimulate productivity growth must be a keystone of economic policy.

Table 1 summarizes the post-war history of growth in productivity. The data show a gradual worsening of the productivity decline as time has passed, with the last few years showing sharp declines. While just-completed revisions of the data may change the magnitude and timing of the slow down, its existence and its costliness are unarguable.

Table 1. Labor Productivity Growth, 1948-80

(Percent change per year)

Sector	1948 to 1965	1965 to 1973	1973 to 1979	1978 IV to 1979 IV	1979 III to 1980 III
Private business sector. . .	3.2	2.4	0.8	-0.9	-0.1
Nonfarm.	2.6	2.2	.6	-1.1	.1

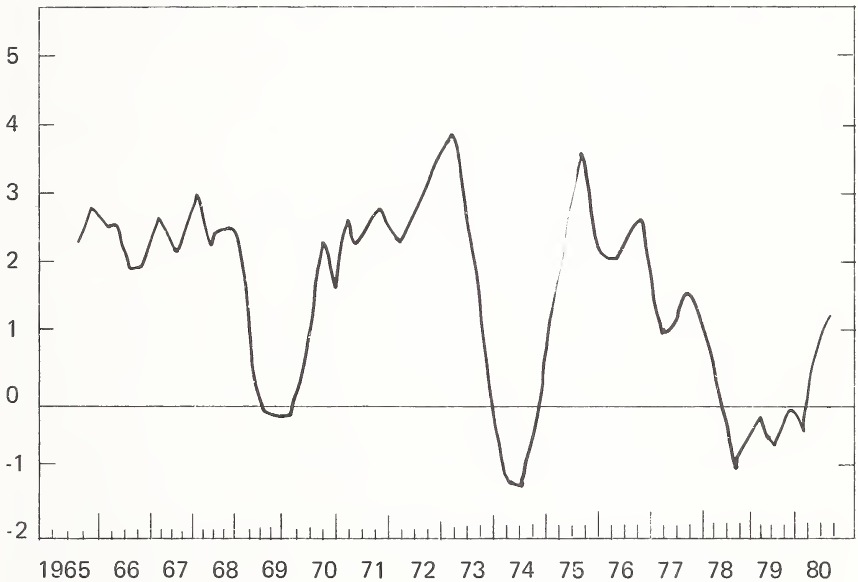
Note: Data relate to output per hour for all persons.
Source: Department of Labor, Bureau of Labor Statistics.

Some of the decline in productivity results from the way we measure it. In particular, productivity measurement counts as an input among the costs of governmental and private actions to ensure a cleaner environment, a healthier workplace, and safer consumer products, but it does not count the benefits of these actions as forms of output.

It is difficult to interpret measures of productivity such as those in Table 1 without first distinguishing between changes caused by the business cycle and changes caused by longer-term factors. Because it is costly to hire or fire, businesses typically do not reduce their work force proportionally when demand slackens or increase it proportionally when demand is expanding. Chart 1 presents the recent history of productivity growth after correction for these cyclical influences. As the chart vividly shows, productivity grew very slowly during most of the years since 1973 and on several occasions actually declined.

Chart 1. Productivity Adjusted for Cyclical Variation

(Percent change from 4 quarters earlier)



Note: Data are for private nonfarm business. All persons.
Source: Council of Economic Advisers.

It would not be surprising to discover that the slowdown has many causes. Measured productivity growth is a distillation of a number of changes and influences. Many researchers have been in agreement that a number of factors have contributed in roughly equal magnitude to the slowdown. These factors have been discussed in past *Reports.* In addition to increased governmental regulations, particular attention has focused on increases in energy prices, declines in the rate of growth of capital relative to labor, and decreases in spending on research and development. But there has also been widespread agreement that a large portion of the slowdown has not yet been explained.

One of the causes of the decline in productivity growth has been the decline in growth of the capital stock relative to the labor force. Because a rising share of capital formation has been devoted to adjustments to cope with higher energy prices and comply with environmental and safety regulations, a diminishing fraction of investment has been available to effect gains in productivity. Although these developments may not have been the primary causes of the productivity slowdown, increasing capital formation would nevertheless be an effective way of reversing the slowdown. Many of the factors affecting productivity cannot be directly or immediately influenced by the government, but economic policy—especially tax policy—can influence the pace of capital formation.

As a rule, an increase in the amount of capital invested per worker is associated with an increase in output per worker, that is, in increased productivity.

There are two reasons for this. First, processes that generate more output per worker usually require more capital per worker, and second, increasing the ratio involves putting newer capital into place. The newer capital is likely to embody more advanced technology and will therefore increase the efficiency of the capital stock.

During the 1960s the capital-labor ratio grew at an average rate of about 3 percent per year; over the last 5 years, however, the ratio has remained roughly constant. This development has been due to both the slower growth in the capital stock and the more rapid growth in employment and hours worked (Table 2). The 1974-79 deceleration in the growth of capital is somewhat at odds with the rough stability in the investment share of GNP over the same period and requires some explanation. A greater share of investment is now being spent on relatively short-lived assets. The ratio of investment in equipment to investment in nonresidential structures has increased in recent years. The result is that each dollar of ***gross*** investment now yields less ***net*** investment because the capital stock is depreciating more rapidly.

Table 2. The Investment Share and Growth in the Capital-Labor Ratio 1949-1979

Period	Real business fixed investment as percent of real GNP[1]	Percent change, average annual rate (end of year to end of year)				
		Net capital stock (non-residential)[2]	Employ-ment[3]	Hours[3]	Capital employ-ment ratio	Capital hours ratio
1949-59	9.1	4.0	1.1	0.7	2.9	3.2
1959-69	9.8	4.6	1.6	1.2	3.0	3.3
1969-74	10.5	4.2	1.2	.5	2.9	3.7
1974-79	10.3	3.0	3.1	2.8	-.1	.2

[1] Average annual investment—GNP ratio, in percent.

[2] Net fixed nonresidential business capital, 1972 dollars, end of year.

[3] For private business, all persons. End of year calculated as average of year's fourth quarter and following year's first quarter.

Sources: Department of Commerce (Bureau of Economic Analysis) and Department of Labor (Bureau of Labor Statistics).

To restore the growth of the capital stock per worker to that of the 1960s would require that the share of investment in GNP rise by at least 1 percentage point from its recent average of about 10.5 percent. Such a development should, at a minimum, restore the productivity growth lost from this source. Further improvement would require yet more investment.

Apart from the necessity of improving the productivity growth rate, there are other reasons why future economic policy should encourage increased investment. Last year's *Report* discussed these needs in detail. The average age of the capital stock at the end of 1979 was 7.1 years. This suggests that much of our plant and equipment was put in place when oil prices were much lower than they are now. Higher energy prices have shortened the service life of older and less energy-efficient capital and have made the speeding up of its replacement nationally beneficial. The magnitude of these investments is difficult to estimate, but it could represent another 1 percent of GNP per year.

Additional investment requirements arise from the need to continue domestic production of oil, coal, and natural gas at sharply higher investment costs per unit of energy produced and to expand the investment devoted to alternative energy sources. Conservatively estimated, they amount to another .5 percent of GNP.

During the late 1960s and early 1970s, before the first surge in oil prices, real business fixed investment averaged about 10.5 percent of GNP. In 1978-79, the investment share averaged slightly higher, around 10.75 percent, probably reflecting additional investment in the energy industries. On the basis of a rough judgment, continued investment of about 10.5 percent of GNP would meet the "normal" requirements of a moderately growing economy and hold the capital stock per worker approximately constant, as it has been in the past 5 years. But it would not provide for an expansion of capital per worker or for the nation's increased needs for energy investment.

Meeting these objectives will require much greater investment. Since the growth of aggregate demand and total GNP will be constrained in the years immediately ahead by the need to reduce inflation, the extra investment cannot come from additional GNP growth but will have to displace consumption or government spending, the other major components of GNP. According to the estimates presented earlier, the share that investment takes in total output will have to rise substantially from a normally expected 10.5 percent or so to 12.5 or 13 percent, and the combined share of consumption and government spending will have to fall by a corresponding amount.

It is virtually certain that such a large increase in the investment share will not occur without deliberate government policies. The major elements of such a policy lie in a combination of federal tax measures and expenditure control. In the future, federal personal tax receipts will take a steadily increasing share of personal income as inflation pushes taxpayers into higher brackets. As oil prices are decontrolled, revenues will be transferred from purchasers—who will pay the higher prices—to the federal government through the windfall profits tax. For both of these reasons the ratio of taxes to GNP will tend to rise and the growth of consumption will fall. If federal expenditures are controlled so that their share of GNP does not rise, periodic tax reductions will be possible. Indeed, they will be necessary to prevent even moderate economic growth from being choked off. If a sizable fraction of those tax reductions concentrates on encouraging investment rather than restoring the growth of consumption, the share of investment in GNP can be raised. Of course, if the share of federal expenditures in GNP is not merely stabilized but reduced, the room for increasing the investment share of GNP through investment-oriented tax cuts will be even larger.

Within this framework, tax reductions designed to increase the share of investment in GNP must meet two requirements: they must increase the demand for investment goods, and simultaneously they must increase saving, that is, they should not increase consumption. These two requirements are closely related, but they are not the same. There are a number of measures that might seek to increase saving but have little, if any, effect on the volume of business investment. Forgoing tax cuts, letting effective tax rates increase, and creating a large federal budget surplus, for example, would appear to be one way of increasing national saving. Although such a policy would make possible a decline in interest rates, it would also create a substantial fiscal drag, reduce economic growth and private saving, and probably yield no increase in business investment spending. Conversely, measures that increase investment demand without making room for it with an increase in saving will yield an excessive growth in total demand and renewed inflationary pressure. Both aspects of the problem are important. Given the determinants of investment, what tax policies can best increase the demand for investment goods? What form of tax reductions is most likely to be channeled into saving rather than consumption?

Expectations about future growth are critical in determining the volume of investment demand for the economy as a whole. But the discussion above suggests that investment needs to increase by more than the amount that would be associated simply with a normal expansion of output. A number of factors influence the amount of capital that firms want to use to produce a given amount of output. Chief among them are the attractiveness of the return on capital investment compared with other uses of investors' funds, the perceived riskiness of corporate investment, and the cost and availability of capital.

The experience of recent years demonstrates the deleterious effects inflation can have on investment. High inflation rates increase the perceived riskiness of investment, and this increased uncertainty makes planning for future capital needs more difficult. The information about relative demand that is contained in price changes becomes clouded when inflation is high. In addition, increasing rates of inflation are ordinarily accompanied by the expectation of sharply higher interest rates and monetary stringency. The expected slowing of growth in demand reduces the incentive to add capacity.

But by far the most important effect of inflation on investment is its impact on tax accounting provisions and depreciation allowances. Depreciation is a cost of earning income from fixed capital assets. This cost is the reduced value of the asset due to use, aging, and obsolescence. The depreciation allowed for tax purposes is based on the historical cost of an asset. When inflation occurs, allowable depreciation is reduced relative to the cost of replacing the asset at today's price. Inflation therefore raises the tax on capital and reduces the rate of return on investment, and this problem worsens as the rate of inflation increases.

The inflation-induced increase in the tax on income from business plant and equipment is partly offset by the inflation-induced reduction in the tax burden of borrowers. Firms are allowed to charge the full value of their interest payments against income, even though a portion of these higher interest payments amounts to the repayment of real capital to lenders. The effect on the return to investment of this "excess" deduction varies with the proportion of investment that is debt-financed. It also varies with the extent to which inflation is reflected in interest rates. Since an important part of investment is not debt-financed, clearly inflation's tax-increasing impact on the value of depreciation allowances outweighs the tax-decreasing impact of excess deductions on the return to business investment.

Some have suggested that the inflation-induced distortion of tax depreciation could be corrected by indexing the value of existing business assets to allow replacement—rather than historical—cost depreciation. But indexing the value of assets would ignore the interest rate offset described in the paragraph above. Moreover, as with all indexing schemes, its administrative and accounting problems would be quite severe, and almost any simple index imaginable would introduce distortions of its own. For these and other reasons, indexing is not an attractive means of correcting the inflation-induced distortion in depreciation allowances.

Policymakers have three principal measures to influence investment through the tax system: changes in depreciation allowances, changes in the investment tax credit, and changes in the corporate income tax rate.

Since the effect of inflation in depressing the value of depreciation is such an obvious factor in the recent decline in after-tax rates of return on capital assets, the liberalization of depreciation allowances is an attractive way to enhance investment. It not only provides an overall incentive for investment but, if carefully designed, can also correct some of the distortions in investment that accompany inflation. Under proposals for accelerated depreciation, the allowable depreciation on capital assets would be increased. This would permit firms to write off their capital purchases faster. The changes would affect two determinants of business investment. First, they would increase the after-tax yield of capital investment and thus its attractiveness. Second, they would increase business cash flow and thereby supply a portion of the funds needed to finance additional investment.

Increases in the investment tax credit would have a similar impact on investment incentives. The investment tax credit reduces the purchase price of eligible equipment. It thus provides a direct incentive by raising net return and by increasing after-tax cash flow.

A reduction in corporate income tax rates, on the other hand, influences investment by increasing after-tax profits. This tends to be a less effective stimulus to investment than either accelerated depreciation or increases in the investment tax credit because it has a smaller impact on the net return from new purchases of capital assets. In addition, depreciation liberalization or an increased investment tax credit are available to a firm only to the extent it invests, but a corporate tax reduction would be available whether investment is undertaken or not.

Any increase in the investment share of GNP must be accompanied by a corresponding increase in the saving share of GNP. Total national saving comes from three sources: individuals save out of their personal income; businesses retain, and thereby save, some of their profit income; and governments save when they run a budget surplus or dissave when they run a budget deficit. It is total national saving that supports total investment. A portion of saving flows into residential investment, investment in inventories, and net foreign investment. The remainder is available to finance business purchases of plant and equipment.

The federal government has many policy options for changing the level of national saving and thereby supporting a higher level of aggregate investment. But it is important to realize that no one sector works in isolation. A given sector's increase in saving may be partially or fully offset by another sector's dissaving.

Personal tax cuts designed to increase specific types of saving, such as an increase in the amount of tax-free interest from passbook savings accounts, are likely to be the least effective ways to increase total saving. They will increase the flow of saving into those instruments whose after-tax returns have been raised, but they will do so primarily at the expense of those forms of household saving whose after-tax returns have not been raised. They will reshuffle personal saving but increase its amount very little.

General reductions in personal tax rates would increase personal income, an increase that would itself lead to higher saving. In addition, the higher after-tax return on saving may induce still further increases in saving. This is more likely to occur if the personal tax cuts are directed at higher-income individuals who tend to save relatively more of their additional after-tax income. But there is substantial evidence that, in any case, the personal saving rate responds very little to changes in rates of return or in the tax structure. A large part of the personal tax reduction would therefore go toward increasing consumption.

The most effective avenue accessible to the federal government to increase the volume of saving is to reduce taxes on business income. Cuts in business taxes would lower government saving, but a large part of the tax cut would flow into business saving. Business after-tax cash flow would be increased. In time, part of the increased cash flow would lead to higher corporate dividends. A very large part, however, would be allocated to an increase in retained earnings —i.e., saving. Evidence suggests, for example, that corporations save more than 50 cents from every additional dollar of after-tax income. Furthermore, some portion of any dividend increase would find its way into personal saving. By contrast, giving the tax cut directly to households would have a smaller effect on saving because households are likely to save a much smaller fraction of every dollar of additional disposable income.

It seems wise, then, to focus government efforts on the sector most likely to allocate a large part of any tax relief to saving—business. A business tax cut would result in relatively large saving, and incentives to expand investment demand would simultaneously improve. It is this approach that lies at the heart of the President's Economic Revitalization Program.

The Integration of Demand-Side and Supply-Side Policies

Tax reductions which induce additional saving and investment will contribute to faster productivity growth, and this in turn will help reduce inflation. A number of critical questions arise, however, about the appropriate type, magnitude, and timing of any tax reductions. First, what kind of an increase in productivity might reasonably be expected from investment-oriented tax cuts of various sizes, and what would be the associated reduction in inflation? Second, to what extent would the improvements in productivity and other supply-creating aspects of a tax reduction offset the increase in the aggregate demand they would cause? More generally, how would tax cuts aimed at increasing supply fit into the framework of fiscal restraint required to reduce inflation?

Although the effect on investment of a given loss of tax revenues would vary with the form of the reduction (accelerated depreciation, larger investment tax credit, or lower corporate income tax rates), the evidence suggests that each dollar of reduction in annual business taxes might, at the outside and after several years, generate slightly more than a dollar in business fixed investment. To increase investment by 10 percent, a business tax reduction of at least $30 billion—or about 1 percent of GNP—would be necessary. This larger volume of investment, maintained from 1981 through 1985, would increase the capital stock by about 5 percent after allowing for depreciation. On the basis of the historical relationships between output and capital, such an addition to the capital stock might generate a total increase in the level of productivity of at most 1.5 percent by 1985, or about 0.3 percent per year. In view of the declining rate of productivity growth which the nation has experienced in recent years, however, this small improvement would be significant.

Such a rise in the productivity growth rate would not be likely to induce a faster rise in money wage demands. Therefore, since the growth of unit labor costs equals the increase in compensation per hour minus the rate of growth in productivity, the faster productivity growth rate should lead to a slower rise in costs and prices. In turn, a slower rise in prices would help to reduce the growth of wages, leading to a still further slowdown of inflation. All told, an investment-oriented tax cut amounting to about 1 percent of GNP might produce a 0.3 percentage point rise in productivity growth that would translate, after several years, into just over .5 percentage point reduction in the inflation rate.

Tax reductions have two principal effects. On the one hand, individuals and firms will buy more goods and services. As a tax cut is spent and respent throughout the economy, the resulting increase in nominal GNP will exceed the orignial tax cut. As a result of this multiplier process, aggregate demand will rise by more than the tax cut. But tax cuts also increase the supply of goods and services. Since lower tax rates allow individuals and firms to keep a larger fraction of their income after taxes, the lower rates affect incentives to work, to save, and to invest the savings, thus increasing potential GNP.

Although the magnitude of the multiplier varies according to the nature of the tax cut, aggregate demand typically rises by about twice the size of a reduction in taxes. Thus, a tax cut equal to 1 percent of GNP will increase aggregate demand by about 2 percent. To match the increase in demand, a 2 percent increase in supply would also be required. To the extent that its supply response is less than the additional demand it creates, any tax reduction adds to the pressures of demand on the rate of inflation.

But there are two ways in which such tax cuts can be made while demand is still restrained. First, tax reductions may offset increases in other taxes. As discussed earlier, inflation pushes taxpayers into higher tax brackets, so that the average effective tax rate—the ratio of tax revenues to GNP—rises. Consumption is depressed and economic growth reduced. In the years ahead, periodic tax reductions will therefore be both possible and necessary to keep aggregate demand from falling. Second, a tax reduction accompanied by federal spending reductions of roughly the same magnitude will not change aggregate demand; hence, even if the supply response to a tax cut is smaller than the demand response, inflationary pressures will not be generated.

Thus, it is clear that the design and timing of supply-oriented tax cuts depend importantly on the specific relationship between the demand-side and supply-side responses. If such tax reductions fail to generate enough supply to offset the additional demand they create—and the evidence discussed below suggests that this is the case, particularly for personal tax reductions—they must then be integrated like any tax cut into policies of demand management.

A 10 percent reduction in marginal tax rates on individuals (approximately a $30-billion personal tax cut in 1981) would increase the total demand for goods and services by $60 billion, or 2 percent of GNP. It could also lead to increase in individual work and saving in response to the lower tax rates and thereby increase potential GNP. How much of the increase in demand would be matched by such increases in supply?

The additional production that results from lowering taxes on labor income depends both on changes in the quantity of labor supplied (for instance, the total number of hours worked) and on changes in the average productivity of labor.

Higher after-tax wages make work more attractive. This encourages new entrants to join the labor force and those already employed to work longer hours. Since after-tax incomes have risen, however, people can also afford to work less—to take longer vacations or to shorten their workweeks. Whether the former effect would or would not exceed the latter effect is hard to predict. The preponderance of evidence suggests that for adult men the two effects approximately offset each other; that is, a cut in income taxes increases the supply of adult men in the work force only slightly, if at all. Women, on the other hand, and particulary married women, respond much more strongly to higher wages. In the past, the number adult women in the work force may have increased by as much as

1 percent for every 1 percent increase in take-home pay. Although women are more responsive to changes in their wages than are men, men still outnumber women in the labor force and on the average earn substantially more. Therefore, a reduction in personal income tax rates would increase the total supply of labor only slightly.

Whether an increase in the labor supply would be accompanied by an increase in productivity is uncertain. While most business investment enhances productivity, an increase in the labor supply would not improve productivity unless it increased the average quality of work performed or the intensity of effort. Productivity might actually fall as the supply of labor increased if the additional labor supply consisted, on balance, of less skilled or less experienced workers.

On the other hand, some have argued that the increased supply of labor from high-income, high-productivity workers would outweigh the increased supply from other workers, so that the average productivity of the labor force would rise. This could happen if high-productivity workers were more sensitive to a given percentage change in after-tax earnings, or if the tax reduction represented a larger percentage change in their take-home pay. Since high-income workers are a small fraction of the labor force, these influences would have to be large to alter total productivity significantly. Studies of high-income workers generally do not find them much more responsive to equal percentage increases in after-tax income. However, a 10 percent across-the-board reduction in tax rates would also mean a larger percentage increase in the after-tax earnings for these workers because their households are in high marginal tax brackets. A 10 percent tax cut is, therefore, likely to produce a somewhat larger change in the supply of high-income workers. Still, even in high-income households it is in fact second-income earners—generally those who have lower productivity—who are apt to be the most responsive to lower tax rates.

Given these two opposing forces—the lack of experience of new workers and the possibility of a greater-than-average influx of higher-income workers—it seems unwise to assume that a personal tax cut will improve the average productivity of the labor force.

With all the relevant factors taken into account, the limited response of the supply of labor and of productivity to a 10 percent reduction in personal income tax rates is likely to produce an increase in potential GNP of perhaps 0.2 percent to, at the most, 0.6 percent. This result follows in part from evidence suggesting that such a tax cut would induce an increase in labor supply between 0.3 and 1.0 percent. According to past relationships between labor and production, such an increase in labor supply would lead to the modest increase in potential GNP mentioned above.

A reduction in personal income tax rates increases both the income out of which an individual worker can save and the after-tax return to saving. It would also tend to discourage borrowing by reducing the value of the income tax deduction for interest payments. If the increases in personal saving find their way into additional business investment, productivity will rise.

Most empirical studies have concluded that changes in personal income tax rates would have only a small effect on personal saving. At best, a 10 percent reduction in tax rates would increase personal saving less than 3 percent. This means that the saving rate—the average share of personal saving in disposable income, which over the last 5 years has averaged 5.7 percent—would rise by no more than 0.2 percentage point. The additional saving would at most be equivalent to only about 0.2 percent of GNP.

Even if every dollar of personal saving that resulted from a 10 percent tax cut were invested in business plant and equipment—and some, in fact, would flow into housing—the effects on output and on productivity would be small. If the tax cut and the higher saving continued for 5 years, the additional saving and investment would increase potential GNP by less than 0.3 percent and lead to a negligible increase in the annual rate of productivity growth.

This examination of likely responses thus suggests that even under the most optimistic circumstances, a 10 percent reduction in tax rates would not induce enough additional work, saving, or investment to offset more than a fraction of the 2 percent increase in aggregate demand that would accompany the tax cut.

It was pointed out earlier that a tax cut that liberalized the business depreciation allowance or increased the investment tax credit could, after a time, have a fairly substantial effect on the nation's productive potential output by perhaps 1.5 percent over a 5-year period.

This, however, would still be less than the 2 percent rise in aggregate demand that would also be generated. More importantly, the increase in demand would come relatively quickly, most of it within 1.5 to 2 years. The increase in supply, on the other hand, would occur very gradually. As a consequence, the tax cut would tend to increase demand pressures, especially in the years immediately following it. While tax reductions that are effective in raising investment are essential in a long-term strategy to promote economic growth, business tax cuts, like personal tax cuts, must fit into an overall framework of fiscal restraint.

This analysis of the macroeconomic effects of federal tax reductions suggests several conclusions for the development of fiscal policy:

First, specific investment-oriented tax reductions for business are likely to increase saving, investment, and productivity by a much more significant degree than cuts in personal income taxes.

Second, productivity-oriented tax reductions will yield improvements in the inflation rate that are helpful and significant, but still relatively modest if the underlying inflation rate is 10 percent.

Third, the supply response, while a critically important feature of any tax reduction, will be substantially less than the demand response, particularly in the short run.

Fourth, since reductions in both business and personal taxes will increase demand faster than supply, they must be designed and carried out in ways that are consistent with the demand restraint needed to reduce inflation.

It is sometimes alleged that the potentially inflationary effects of a large tax cut can be avoided if the Federal Reserve steadfastly pursues its goal of keeping the growth of the monetary aggregates within tight targets. But if taxes are reduced while the Federal Reserve pursues an unchanged monetary policy, aggregate demand will nevetheless increase, especially in the short run. The increase in demand will lead to a rise in interest rates that would dampen the increase in aggregate demand but not eliminate it. Additional inflationary pressure would then result.

A very large tax cut without the necessary spending cuts would lead to both an increase in inflation and a sharp rise in interest rates. Some, and perhaps all, of the stimulus to investment from tax reductions would be undone by the higher interest rates and the greater uncertainty engendered by a new round of inflation.

Monetary restraint is absolutely essential to the reduction of inflation. Tax measures focused on increasing supply can made a significant contribution. But there will be a continuing need for careful and prudent fiscal policies to restrain demand. In recent years the nation has come to appreciate the potential value of supply-oriented tax policies. In the process of learning some needed lessons about supply-side economics, however, the nation cannot afford to forget its hard-learned lessons about the need for demand-side restraint.

PUTTING THE SUPPLY AND DEMAND SIDES OF ECONOMICS TOGETHER

Commentary

There are different schools of thought about the effects of budgetary and monetary policies on an economy. One, which we can call the demand side, stresses effects on purchasing power. Another, which we can call the supply side, stresses incentives to produce. Let us examine each of these in turn and focus on the likely consequences for prices and quantities.

An important economic problem is that, as public and private actions are taken to increase output, prices tend to increase. If we let P represent an index of the general price level, and Q an index of aggregate output, then the relationship between the price level and aggregate output may be represented on a graph:

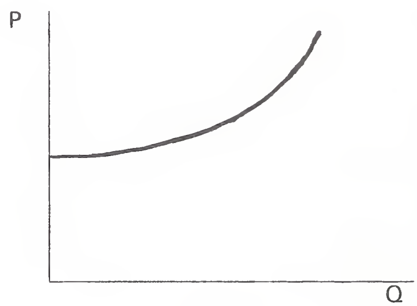


Figure 1

The flat part of the graph suggests a range in which output can be increased without concern for inflation. This range, however, may be one in which unemployment is the paramount concern. As output increases, a range is reached in which inflation becomes a problem. This inflationary range may or may not include unemployment.

The upward sloping part of the graph reflects inflationary pressures in an economy approaching full employment of plant and labor force, at least in some sectors. Among the several structural factors which help to explain a rise in the general price level as output expands is wage rigidity. Wage levels tend to resist downward pressures. When relative prices change, wages may ratchet upwards, but they tend not to move down. Wage rigidity is partly explained by government policies put in place since World War II to expand the economy and to protect or bail out disadvantaged firms or individuals. In addition, modern industry is simply not organized according to the textbook descriptions of a perfect market. Labor is a fixed asset that costs something to train and that a firm does not want to lose. Wage bargains, rather than competition, set rates. Product prices, too, are sluggish on the down side and tend to ratchet upward, given the rules by which firms operate in our complex economic system.

Our discussion of the demand and supply sides of economics will reflect different views about how an economy moves along the curve shown in Figure 1 and about how it shifts the curve to a different location. Let us take up the demand side first.

The demand side view of a tax cut is that it puts more purchasing power into the private sector. A rise in household and business incomes after taxes increases spending as well as saving. The increase in demand for consumer and investor goods may call forth more production. But the economy may be in the range of Figure 1 in which it calls forth higher prices as well. An increase in government purchases instead of a tax cut has a similar expanding effect on the economy; the difference is that increased government spending leads toward a relatively larger public sector, whereas decreased taxes lead toward a relatively larger private sector.

The initial increase in public and private spending resulting from an increased government deficit induces additional rounds of spending through a process known as the multiplier effect. The recipient of the first round of spending saves some and respends the rest on a second round. That recipient respends some on a third round, and so on. Because some income is saved on each round, the successive rounds become smaller and smaller. The cumulative effect of indirect inducements to spend may be twice the initial increase in purchasing power.

If the money supply is held constant after a tax cut or spending increase, more of the existing supply is required for transactions and less remains for portfolio management. With a rising demand for money, interest rates rise. The rise in interest rates is a disincentive to consume or invest, and it limits the extent of the expansion in output. It also adds to costs of production and can put upward pressure on the general price level.

Hence, deficit spending (tax cuts or expenditure increases) needs to be accompanied by an accommodating easy monetary policy if the full output-increasing effects of the policy are to be realized. Similarly, if the economy is experiencing inflation (that is, if the economy is far to the right on the curve in Figure 1), then price increases can be moderated by budgetary surpluses (tax increases or expenditure cuts) and tight monetary policy (high interest rates). These curtail output while easing price pressures. If the government has budget deficits during a period of inflation and relies entirely on tight monetary policies to fight inflation, imbalances can occur.

The supply-side view of a tax cut is that it provides incentives to save and invest, to work, and to increase output. Higher disposable personal income from additional work encourages more full- and part-time entrants into the labor force and encourages additional effort from those who have jobs. Higher after-tax incomes to families encourage an increase in individual saving. Higher after-tax incomes to business induce investment, not only of the increase in cash flows but also of individual savings.

Supply-side incentives to increase investment, productivity and output are more sensitive to a change in marginal tax rates than to a change in average rates. Under a progressive tax system, the marginal rate is higher than the average rate for each individual taxpayer. A reduced average rate with no change at the margin can be affected, for example, by an increase in exemptions. This reduces the tax on existing income and investments, some of which adds to saving and to possible new investment, but it does not induce added work or investment to the extent that a reduction of the marginal tax rate would. In the extreme, a poll tax provides the greatest marginal inducement to invest because the additional tax on additional income is zero.

With little or no inflation, a tax cut will lead to increased output and employment by means of a move to the right along the flat part of the curve in the figure. With inflation, the increased incentive to produce will shift the upward sloping part of the curve so that additional output, which can ease inflationary pressures, will be realized. The process of saving is not the same as that of investing. Supply-side economics attends to inducements to save and inducements to invest. The main policy instrument is a tax cut. The main route to limiting inflation is to induce more saving and investments which increase productivity and output, reduce costs, and limit upward pressure on prices.

Now, how do we put these two sides together? Clearly, a tax cut will produce a movement along the curve shown in the figure as well as a shift in the curve. The cut can encourage more demand; it can increase productivity and output; it can add to costs to the extent that higher interest rates are costs of production and consumption; and it can reduce costs to the extent that taxes are costs. Let us focus on the prospective shifts in supply and demand. If demand increases more than output does, inflationary pressures can be expected to increase, and if supply increases more than demand does, inflationary pressures will abate in response to a tax cut.

A tax cut amounting to 1 percent of aggregate income is likely, through the multiplier effect of demand-side economics, to induce a 2 percent increase in demand. If supply increases by more than 2 percent, there will be no abatement in inflationary pressures. If supply increases less than 2 percent, inflation will grow.

If one assumes diminishing returns, then the gains in productivity and output decrease as the level of investment increases. This seems to argue against the prospects of the supply effect of a tax cut's exceeding the demand effect. On the other hand, one could assume increasing returns and make a good case for the supply-side scenario. Hence, putting the two sides together turns out to be an empirical question—one for which we have very little data. Perhaps the best study of this is an econometric model which simulates the long-term supply response to a tax cut. This model estimates that if *all* of the tax cut were to go into investment, a 1 percent tax cut this year would be likely to induce an increase in supply of 1 to 1.5 percent, and this would be attained over a five-year period. This suggests considerable inflationary pressures in the short run that become moderate but positive in the long run. If *all* of the tax cut were to provide work incentives instead of saving and investment incentives, supply might increase on the order of .5 percent. This includes incentives to join the labor force as well as to increase efforts of those with jobs. It supposes that marginal increments of added work will add less to output than the average output of all employment.

The conclusion is that any tax cut alone, when supply and demand side effects are both accounted for, will have more of a demand effect than a supply effect. As long as the economy is close to capacity it will, therefore, be inflationary. To avoid this result, when there is inflation a tax cut must be accompanied by spending cuts. Further, since the government budget is now in deficit, spending cuts might better precede and/or exceed any tax cuts in order to reduce the degree of reliance on monetary policy to offset an inflationary budget deficit. Otherwise the money supply must be managed so as to maintain high interest rates, with their disincentives to invest and their additions to costs of production and consumption.

The U.S. economy still suffers high unemployment (7.5 percent), high inflation (10 percent), high interest rates (the prime rate is around 20 percent), a feeling that the private sector needs to grow relative to the public sector, and too much regulation in certain areas. Past policies have resulted in continuing budget deficits and high interests rates. Debate over economic policy has led to proposals for:

1. tax cuts,
2. spending cuts,
3. deregulation, and
4. high interest rates.

Both supply-siders and demand-siders tend to arrive at the same list. But they start from different assumptions, and they view the policies as achieving their results through different channels. More important, they differ on the degree, timing, and targets of deregulation or cutting.

My own opinion is that too much emphasis on a tax cut—which is too soon, too large, and too long-run—will exacerbate inflation. Spending cuts need to come first and/or be larger. There is considerable room for debate on which programs should be cut and which deregulated. And there is a need to get the budget policy in order so that interest rates—which, when they are too high, can be disincentives to invesment and sources of cost-push inflation—can be reduced.

Defense

The role of the Defense Department in economic policy for the 1980s should be that of a catalyst, a catalyst in the sense that advanced technology in the design of new weapon systems needs to be introduced into American industry. This will require the acquisition of new weapon systems which will motivate industry to make the capital investment in the equipment needed to produce the advanced technology.

The acquisition cycle is divided into five phases: initiation, validation, development, production, deployment, and operation. During the past several years, defense acquisitions have stopped short of production. Stopping at production does not expose industry to the new technology nor does it induce industry to put up the capital to produce a yet-undemonstrated technology. Research which comprises validation and development is indeed necessary to explore new initiatives, but research soon stagnates if the new initiatives are never demonstrated. Systems with advanced technology must be produced in quantity, must be supplied to operational units and must operate in an environment that simulates normal conditions before industry can see the public use for the technology. Two important occurrences follow each other from the production of new advanced technology: more innovations come forth, and spinoff industries spring up to fill the demand for the new technology.

In addition to providing national security, successful demonstration of new technology, by a multiplier effect, triggers additional ideas for applying the technology in other fields. These new applications expand the market for the technology further and trigger still more ideas for applying the new technology outside even those fields. In turn, spinoff enterprises spring up to supply and service the consumer goods that come from the new technology. These enterprises provide the tax revenue so essential to a healthy economy.

Supply-side economics recognizes the close relationship between advancing technology and the health of the economy. With more dollars for investment through favored tax cuts and with the stimulation of advanced technology by increased military spending, a new source of tax revenue can be expected. This revenue can then be used to balance the budget and provide for the welfare of the nation.

International Trade Issues

In implementing measures to increase domestic employment, productivity, and output, one must consider the impact of international trade. Vigorous export performance can significantly contribute to achieving these goals. In the quarter century following World War II, the United States experienced significant trade surpluses. Both imports and exports expanded rapidly. This expansion enabled the U.S. economy to have access to cheaper raw materials and commodities, provided for employment growth, created capital for new investment, and contributed to a rising standard of living. Recent U.S. export performance, however, has been wanting. A trade deficit of $24 billion resulted in 1980 as exports totaled only $221 billion and imports $245 billion. This deficit followed record trade deficits in 1978 and 1979. In 1981, the deficit may be reduced by several billion dollars, although an increased deficit is also possible.

In the longer term, the outlook for continued improvement is uncertain. Key developments clouding U.S. export performance include anticipated slower growth rates for the major industrial countries and the erosion of price benefits gained from the dollar depreciation in the late 1970s. The U.S. faces growing competition from the more advanced LDC's such as Korea, Taiwan, and Mexico.

As the U.S. economy accelerates in the 1980s, demand for foreign capital goods will also rise sharply. Moreover, rising personal incomes should increase the demand for foreign consumer goods.

Foreign governments have taken a more aggressive position in supporting their exporting industries than the United States has. Moreover, U.S. industry perceives the U.S. Government as having established significant ***disincentives*** to exporters, thereby undermining their efforts to expand exports and compete for major foreign project contracts.

The following are key U.S. Government export disincentives frequently mentioned by U.S. industry:

- *Taxation of Americans working abroad.* The United States, unlike other nations, significantly taxes the income of Americans working abroad. This raises the cost of employing Americans, thus leading to either higher price quotations by U.S. firms competing for foreign contracts or the substitution of lower-cost foreign labor in place of Americans.
- *Extra-territorial application of U.S. antitrust laws.* American industry believes these laws effectively prohibit joint actions in situations in which several firms could join in building on a multi-billion dollar development project.
- *Foreign Corrupt Practices Act.* Ambiguities in this law, as well as the inability of small and medium-sized firms to supervise directly the actions of their overseas agents, appear to be disincentives to expanding the base of U.S. exporters. Only 10 percent of the firms with the potential to export are currently exporting.
- *U.S. Antiboycott Laws.* The U.S. has three differing sets of antiboycott laws administered by four different government agencies. Industry believes the confusion discourages exporters and recommends that it be resolved.

In addition to reducing disincentives, industry also perceives the need for additional U.S. export incentives. These include the need for expanded export financing to meet other governments' packages, especially on major project and capital equipment transactions. Tax benefits also come into debate, especially the role of the DISC program and the practice of not taxing the earnings remitted to the parent corporations in the U.S.

Another issue is pending legislation to permit the formation of export trading companies that would provide a full range of expert services to firms of any size. Such export trading companies would be an exception to the general principle of separation of banking and commerce.

These questions have to be addressed in the formulation of U.S. Government export policy in the 1980s if that policy is to complement domestic growth initiatives.

Housing and Urban Development

In this paper, I will focus on the subject of housing generally, as distinct from the more complex area of cities and urban development, which are vital parts of the HUD mission also. First, let us examine the conditions of housing from an economic standpoint.

Perhaps the most significant trait of housing in the economy is its high degree of sensitivity to inflation. Housing is thought to presage the turning of the economy by about six months on the upturn side. It is immediately affected on the downside, though usually lowered starts of new units are not felt for about six months. In direct response to high interest there has been a 50 percent falloff in the volume of new starts this year over last year. Further, housing is highly dependent on savings and loans for its source of funds. If the Savings and Loans (S&L) do not have funds, then people cannot borrow money to purchase homes, and builders cannot borrow money to start construction.

Another condition affecting the housing industry is the long period of time associated with the use of the funds. That is, an S&L lends money to a purchaser for 30 years. It hopes that the interest rate it charges reasonably reflects the conditions in the marketplace over the term of the loan. The rapidly rising costs of money in recent years, however, has left many S&Ls in dire straights, with millions of dollars of low-interest loans on their books. They are forced to pay more for money to lend than they are receiving for their portfolios. In December 1980, over half of this nation's S&L's were operating at a deficit.

Along with fewer housing starts come secondary effects felt by the related industries. There is less demand for lumber, household appliances, and home furnishings.

The short supply of housing that results from this downturn has another effect of great significance. There is considerable latent demand in the marketplace. That is, people want single-family homes just as much as if the problems I have discussed did not exist. This demand pushes up prices for the available product. The federal tax policy encourages speculation by allowing equal write-offs for the investor and the resident. This drives prices up even further.

A final condition that bears mention is the leverage potential of real estate investment. Few, if any, sizable investments allow the opportunity for such high loan-to-value ratios as does housing. The advent of federal involvement in the housing industry since the thirties has made this possible. The result during inflationary times, however, is to make speculation and investment in real estate very attractive. The effects of this phenomenon as it relates to policy options for the federal government are discussed below.

Let us now turn to the national policy issues suggested by this discussion. This discussion will not deal with the broader issues of monetary and fiscal policy or the global impact of inflation. Generally, there are three areas of policy that are affected directly by this issue: tax policy, credit policy, and housing policy.

From a tax policy perspective, the nation needs to assess how much it wishes to encourage certain kinds of behavior at the expense of other uses of revenue. Specifically, I refer to the tax benefits to those who invest as opposed to those who simply own real estate. Local taxes, interest, depreciation, and other operating expenses are available to the residential, single-family investor. The point here is the utility in opportunity cost for the alternative use of the funds put into housing investment, as opposed to investments that add to the GNP more directly. Beyond the first home or a vacation property, the effect is to artifically bid up the price of an already inflated product. One could also question the view of depreciation for this type of investment in relation to similar investments. I refer here to single-family investment only.

The sheer volume of funds required to support the housing industry raises the issue of credit policy. Housing consumes huge sums of capital that are therefore not available for other uses. The federal government must address the question, when do these dollars reach a point of diminishing returns as it relates to GNP as opposed to the next best alternative? Moreover, the federal government's assistance to this industry in the form of secondary financing, insurance, and loan guarantees means that it is competing in the commercial capital markets for credit. This in itself drives the price of money higher, assuming the Federal Reserve Board's restraints are maintained as they have been recently. To its credit, the federal government has moved in this area by establishing credit limits for various agencies. These limits have not yet had much effect, but that is more attributable to the political process than to a lack of concern. Finally, there is the real issue of the long-term validity of the mortgage instrument. The fully amortized mortgage is of relatively recent vintage, dating back only to the thirties. What is the position of the federal government with respect to this vehicle for the loan?

I have saved the knottiest problem for the last. What is the housing policy for the 1980s? The central question is how to provide shelter for Americans in the current environment. The factors that bear on this issue are many. The post-war baby boom has entered the housing market looking for shelter like that in which they grew up. Additionally, there is a much higher incidence of single heads of household and singles generally coming to the housing market, with obvious effects on demand and prices.

I have focused on single-family dwellings almost exclusively here, but what about the housing needs of the poor and the elderly? This is primarily an issue of multifamily structures, but the policy issues for the federal government are substantially the same: How will this nation provide shelter for these large and growing segments of the population? I believe the central question for the federal government in the eighties is how it will react to the strongly held value of a single-family home and a plot of ground as the primary vehicle of shelter. This is a very inefficient form of shelter from an energy standpoint. Natural resources are an issue here, too, for surely housing requires far more materials when it is single-family-detached than other types. Moreover, the sprawl that accompanies this type of shelter has major implications for oil consumption and puts a great demand on local government to provide services.

In summary, the area of housing is significantly affected by inflation and government policy concerning inflation. At the same time, housing is one of the most basic of human needs. How this nation and its government deal with changing values and others as old as the country in the face of significant problems of relatively recent origin will provide a major challenge for the eighties and beyond.

Senior-level executives working in the federal government should be aware of the implications of supply-side economics for specific departments and functions of the federal government. Depending on the orientation of the federal budget and cuts proposed, a shift in priorities will take place. Participants need to examine supply-side economics as an answer to our present economic problems and consider its impact on our defense, agriculture, and space programs.

DON PAARLBERG

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From left to right: Jack H. Armstrong, Deputy Administrator, USDA/ACS; Larry F. Thomasson, Assistant Administrator, USDA/Foreign Agricultural Services; Dr. Bruce Wald, Associate Director of Research, Naval Research Lab; and F. Dale Robertson, Supervisory Forester, Programs and Legislation, USDA/Forest Service. *Not in picture:* Hugh H. Wilson, Director, Procurement Policy Division, NASA.

PUTTING THE SUPPLY AND DEMAND SIDES OF ECONOMICS TOGETHER

Don Paarlberg

What is called supply-side economics can be understood only in an historical context. Therefore, we make a brief excursion through that much-neglected field, the history of economic thought.

A controversy arose not long after the appearance of Adam Smith's *Wealth of Nations* (1776) as to whether the economic system was essentially benign or whether it was prone to malignancy in the form of overproduction, unemployment, and depression. A Frenchman, J. B. Say, said in 1803 that the system was benign. He put forth the proposition that the money laid out in the production of goods constituted the demand with which these goods could be purchased. Therefore, said he, there could be no general unemployment, no large quantity of surplus goods, no large-scale depression. Small-scale maladjustment could occur, but nothing serious or protracted. Say's principle was reduced to a simplified, understandable form: "Supply creates its own demand." This was economic orthodoxy for more than a century.

But during the 1930s, we did have serious protracted depression and unemployment. Orthodox economics was without explanation or remedy. It is difficult from this point in history fully to realize the chaos that characterized the economic discipline during those terrible years. How prescribe for a situation which, according to the accepted theory, could not exist?

Into this vacuum rushed a new concept, produced by the eminent British economist, John Maynard Keynes. Keynes published his great work, *The General Theory of Employment Interest and Money,* in 1935. He threw out Say's law and developed a theoretical framework which showed that equilibrium could occur at much less than full employment. He showed that the economy could stagnate with much of its resources unused. The remedy, he said, was to inject income (demand) into the economy by deficit spending and easy

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Professor Emeritus, Purdue University

monetary policy. This would stimulate the economy, putting idle men to work. In effect Keynes reversed Say's dictum; Keynes could be interpreted as saying that demand created its own supply. New demand (income), injected into the economy, would not be inflationary so long as there were idle men and idle plants. If resources became fully used, any new increment of income would express itself in inflation. If the economy became overheated, taxes should be increased, the money supply should be restricted, the excess demand should be siphoned off and equilibrium restored.

Keynesian thought soon replaced classical economics. The discipline underwent the quickest and most comprehensive reform it had experienced in the 200 years of its existence. The Keynesian system was embraced by the Democrats, then in control of the White House and the Congress. It dominated the economic policies of the Democratic party from then until now.

It is easy to see why Keynesian economics triumphed. It had an explanation for the Depression, which classical economics lacked. It had a remedy, which classical economics also lacked. The remedy consisted of government action, the voting of benefits to constituents without extracting taxes from them, which is the most appealing proposition known to a politician.

The difficulty was that the politicians saw only one side of Keynes' prescription. They saw merit in injecting money into the income stream to stimulate the economy. But when the economy became overheated and inflation appeared, they were reluctant to raise taxes and extract money from the people. They took the attractive half of Keynes' proposition and ignored the other half. In this they were supported by many neo-Keynesian thinkers who loaned their influence to this distortion of the master's views. Had Keynes lived he would have been dismayed at this perversion.

Huge amounts of new money were injected into the income stream in the effort to goad the economy into superior performance. Deficit spending, and easy money were substituted for needed institutional reform. Rather than deal with the obstacles to production imposed by particular interest groups (PIGS), the politicians poured out new increments of money. In the zeal to increase demand, production incentives were forgotten and investment in capital goods lagged. In the desire to generate government revenue with which to fund the demand-stimulating programs, taxes in the upper brackets were raised to very high levels. Like a much-flogged horse, the economy began to stumble. The injections of new income, instead of putting resources to work, expended themselves in inflation. We then had—and have—inflation with resources less than fully used.

Keynesian theory can no more explain inflation with unused resources in today's world than classical economics could explain depression and unused resources coexisting during the 1930s. Say had been wrong: supply does not necessarily create its own demand. It now appears that Keynes' interpreters were also wrong: demand does not always create its own supply.

Pity the Council of Economic Advisers, who must recommend economic policy to the President. How can they do this when both the classical and the Keynesian concepts have shown themselves unable to cope? It is as if a plant breeder were told to develop a new wheat, having just been told that the Mendelian principles of genetics were no longer valid.

In a sense, both Say and Keynes were right ***within their assumptions.*** Say assumed that prices and wages would adjust to changing circumstances; the downfall of his theory resulted from institutional arrangements that prevented them from doing so. Keynes assumed that prices and wages had much rigidity and that government policy would be symmetrical: stimulation in slack times and restraint when the economy became overheated. Political failure to apply restraint discredited his system.

However people may disagree with this historical assessment, there is general consensus on the present state of the economy:

1. Unemployment is high by historical comparison, affecting seven percent of the labor force;

2. Our economic system is operating at a low level; our manufacturing plants are running at 75 percent of capacity;

3. Inflation is running at a double digit pace;

4. Efficiency, as measured by output per worker, is declining; and

5. The dollar is weaker than it was in international markets.

Clearly, this is an unsatisfactory situation. The demand of the public is that "something be done." A new Republican Administration has been elected to "do something." The something they have chosen to do they call "supply-side economics."

What is supply-side economics? First, it is an overt rejection of Keynesian economics and, by inference, the economic concepts which have dominated the Democratic party. The Democrats were concerned primarily with the demand side of the economic system. Supply-side economics is in part a return to classical economics and to Say's principle. In some degree it is a synthesis of the old, the very old, and the new, the parts not being entirely consistent with each other. It has features which in the present setting are politically attractive: reduce the rate of governmental growth; cut taxes; reduce regulatory activity. It is presented with new nomenclature and new rhetoric. It is intended to give new hope that inflation can be restrained and our economic performance improved.

The basic idea is that taxes have become so burdensome that they inhibit investment and enterprise. If taxes are reduced for entrepreneurial people, new plants will be built and new capital commitments will be made. The result will be greater efficiency and increased economic activity. This increased activity is expected to generate more taxes and so work toward a balanced budget. In other words, by cutting tax *rates* we generate more tax *dollars.* The plan is to reduce government costs by pruning off nonessential services and by curbing the particular interest groups. This, it is hoped, together with the added tax revenue resulting from greater economic activity, will in time permit the budget to be balanced and will curb the inflationary forces associated with deficits. All this will be associated with monetary policy which is on the tight side. And it is to be accompanied by relaxation of regulations which inhibit the entrepreneurial class. Fiscal and monetary policy are to team up, working together to get the economy going and to curb inflation.

There are two schools of thought as to how to get the economy straightened out. One is the shock treatment, to break the back of inflation by bold sudden strokes, involving a sharp cut in the money supply and sky-high interest rates, with acknowledged severe damage to exposed groups. The other involves "gradualism," to cool off inflation and reduce inflationary expectations, to work toward a balanced budget, to restrain growth in the money supply, to relax government regulation, to provide incentives for saving and investment, and to rebuild a feeling of self-reliance on the part of our citizens. Supply-side economics takes this gradual approach. It is not just a set of economic ideas; it is also a political concept.

Clearly what we have here is not an economic concept that is complete and internally consistent, as is classical economics or Keynesian economics. It is an amalgam. It is eclectic. In it are recognizable elements of the classical system and some unpurged remnants of Keynesian economics plus some elements that appear in neither of its predecessors. In addition, supply-side economics has political and social components. (Its adversaries would say "anti-social.") If offered in the University, supply-side economics might be taught in the Economics Department, in the Department of Political Science, or in the School of Public Administration, or in all three. Presently it is not taught at all.

What are the prospects that supply-side economics might succeed? For that matter, what are the criteria for success? As the rhetoric rolls out, it appears that the new Administration's criteria are qualitative as well quantitative. Apparently the attitudinal objectives are these: a new hope, a growing willingness to venture, greater self-reliance, and the belief that inflation can be slowed down. The quantitative objectives seem to be these: slowing inflation to a rate of 5 or 6 percent by 1984, balancing the federal budget by that year, lifting the real growth rate of the Gross National Product to 4 percent, and reducing unemployement from its 1980 level of 7 percent to something like 4 percent.

In considering the possibility that these objectives might be achieved or approached, we begin by examining the various parts of the package.

It is clear to this writer, and evidently also to large numbers of our citizens as well, that government is overgrown and that parts of it have been captured by the particular interest groups. That budget cutting is in order is agreed as a general proposition, though no one wants a cut in his program. The President's proposal is to cut approximately $49 billion from the Carter fiscal 1982 budget outlay of $739 billion. This is a 6 percent cut. Even if this entire cut were made, which seems unlikely, budget outlays would still be some $40 billion or 5 percent above the 1981 budget. The impact involved in a reduction of this magnitude below the Carter budget may be very important psychologically, but it amounts to less than 2 percent of our Gross National Product. The proposed budget cuts appear to be wholesome from the standpoint of good government and would involve an improved benefit/cost ratio for government services. But the economic leverage seems insufficient to move us strongly toward the economic objectives, that is, unless the modest economic moves generate a sizable psychological change, as was the case when Keynesian economics was embraced 45 years ago.

What of the proposed tax cut? With inflation, the graduated income tax results in "bracket creep," moving people into higher tax rates even though their real incomes are no higher. Unless this is changed, government revenues will in time increase to such a point that they will take a disproportionate and unintended share of our effort. They will become confiscatory; the inhibiting effect on effort and investment which worries the supply-siders will become plain to all. Supply-siders contend that this has already happened. The availability of such enormous tax revenues would be an encouragement to yet more government spending. So, to me, cutting taxes is desirable, though the appropriate amount, the nature, and the timing of the cut are not so clear.

The proposed tax cut is intended to reduce personal income taxes by 10 percent the first year and by an additional 10 percent in each of the two subsequent years. Even if this tax cut were made, 1982 federal revenues would still be $650 billion, 8 percent above their 1981 level. This constitutes a reduction of about 8 percent below what taxes otherwise would be. In speaking of the proposed 1982 tax cut, we are considering an amount equal to 2 percent of our Gross National Product.

The proposed tax cut is the most controversial part of the package offered by the supply-siders, and it has the weakest theoretical underpinning.

The supply-siders want to shape the cut so that most of the benefits, in dollar terms, would go to the entrepreneurs who are among the more wealthy and who have been most hurt by punitive taxes and by bracket creep. The supply-siders' case rests on the belief that these people, if relieved of burdensome taxes, will invest, innovate, and produce. They argue that the tax cut would stimulate the economy and so in time generate more revenue than does the slack economy at present high tax rates. They thus anticipant that the deficit would be reduced and that in time the budget would be balanced. The government would no longer have to go into the financial markets to borrow; the reduced demand for funds would cause the interest rate to fall. Thus lower tax rates stimulate investment, which generates more tax dollars, which helps balance the budget, which reduces government demand for available funds, which lowers the interest rate and further encourages investment. While all this is going on, greater production and the balanced budget help reduce inflationary expectations. Stick beats dog, dog bites pig, pig jumps over the stile, and all get safely home.

Those who oppose the tax cut, generally those called liberals, point out that it would confer its least benefits on the poor. They also fear that a reduction in tax rates would reduce the pool from which benefits for the poor may be drawn. Further, they argue that a tax cut would have an early effect in reducing government income while such increased economic activity as would generate additional taxes would be a long time in coming. In the interim, they say, the deficit would increase and inflation would be the greater problem. Finally, they say that much of the increased spendable income available to the wealthy as a result of the tax cut would go for conspicuous consumption rather than for new capital equipment. They argue, on familiar Keynesian grounds, that tax cuts stimulate demand and are thus inflationary.

Opponents of supply-side economics, generally the liberals and the crypto-Keynesians, are embarrassed by one apparent fact. It was while we were acting out their scenario that the present malaise developed. Clearly, to prescribe more of the same would lack credibility. They are in the same circumstances as were the classical economists when the Great Depression struck. They are without explanation and without remedy. One would hope that their criticism of the new approach would therefore be modified.

In summary, as this writer sees it, what is called supply-side economics offers, in present and prospective circumstances, the best chance to break away from the spending, inflating, and regulating syndrome that has characterized government activity for the past 50 years. Clearly it does not rest on a tidy piece of economic theory. Nor has it been tested. But considering the paucity of alternatives, it has its merits. It has an articulate advocate in the President and a hopeful following among the people. These may be more important attributes than theoretical respectability.

Supply-side economics is a kind of Hegelian synthesis of the classical thesis and the Keynesian antithesis. It is newly born, still not sure it has all its fingers and toes. Obviously it will need some nurture and disciplining if it survives infancy. An optimist—the writer—dares hope that it will avoid the reciprocal blindness of classical economics on the one hand and Keynesian economics on the other, the first of which contended that supply created its own demand and the other implying that demand creates its own supply. One hopes that we would read again the wise words of that great nineteenth-century English economist, Alfred Marshall, who told us that it was as useless to contend which was the more important, supply or demand, as to argue about which blade of the scissors did the cutting.

Commentary

General Overview of Supply-Side Economics

Many different terms have been used to describe economics during the past century. They include the dismal science, the invisible hand, the allocation of scarce resources, and the free market. Economics as a system has been described by Adam Smith in his *Wealth of Nations,* J. B. Say in *Say's Law,* John Maynard Keynes in the *General Theory of Employment Interest and Money,* and many others of similar or lesser stature.

Politicians have generally recognized that most Americans vote their pocketbooks. For this reason, economics has played a large part in the American political process, challenging each political party to search for a sure cure for what ails the economic system at any give time, be it unemployment, inflation, low profits, or high interest rates.

The present Administration's answer to this challenge was to respond with what has been termed "supply-side" economics, the idea being that by stimulating the productive plant or by increasing its efficiency, increased production will be forthcoming. This will reduce unemployment, stimulate investment, increase tax revenues, and reduce inflation. This is all to be accomplished through a program of cutting government spending and reducing government regulation (the much-heralded "get the government off our back" cry). Coupled with this is to be a substantial tax cut aimed at stimulating investment by selectively giving businesses and high income earners the largest cuts.

Will it work? Will "supply-side" economics as a program, if enacted, stimulate investment, increase productivity, and reduce inflation? This is a $64,000 question.

There is little sound economic theory to support the idea that such a program of inconsistent economically related actions will have the desired effect on the economy. However, most items do have wide public support, and their impact may be more psychological than economic.

The three most apparent weaknesses of the proposed "supply-side" economic program are as follows:

1. The program is not based on sound economic principles and is internally inconsistent.

2. The program is only working on the extreme margins of the total economic system. Alleged impacts, if they were to achieve their greatest goals, would affect the economy only minutely.

3. Probably the greatest weakness is that the program deals with the economy as it was conceived during the first half of the twentieth century, that is, as a nice, neat competitive free market system. Significant structural changes have occurred both domestically and internationally to suggest there no longer exists a free market economy. There certainly exists sufficient evidence that the major economies of the world are so closely linked by large multinational firms and trading organizations that tinkering with marginal elements of the U.S. economic system as the "supply-side"program is suppposed to do, will be, from an operational standpoint, largely ineffective. The markets in international currencies, oil, aircraft, steel, automobiles, grains, tires, farm equipment, computers, and a growing list of other commodities essentially link the U.S. with a worldwide economic environment. The Administration's commitment to "free trade" makes this even more true and makes the proposed program even less likely to succeed, especially when the free trade philosophy is marred by threats of Japanese car import limitations and other non-laissez-faire actions attributable to politics rather than economics.

At best, the proposed "supply-side" economic program can be likened to a blind man's swing at his opponent. Chances are slim it will connect with a telling blow, but given the present state of the economic arts, what alternatives are there?

Implications for the Department of Defense

Supply-side economics is defined here as a package of administration proposals intended to facilitate economic recovery. Supply-side economics includes the following dicta:

1. Cut (in constant value dollars) total federal expenditures while permitting some real expansion in defense expenditures.
2. Cut taxes, with the cut directed at reducing the marginal tax rates of the upper middle class and the wealthy, and at increasing corporate depreciation allowances so as to encourage investment in new and more efficient plants.
3. Permit only a modest, steady expansion of the currency, even at the cost of high interest rates.
4. Reduce federal government regulations.

The premise of supply-side economics is that productivity has suffered because of a lack of opportunity for capital formation and a lack of incentive for investment. Cutting government consumption will provide the incentive. The entrepreneurial spirit will be revived. Removal of counter-productive regulations will both encourage this spirit and raise productivity. Tight money will prevent inflation. When the investment produces a greater supply of goods and services, everyone will be better off.

Dr. Paarlberg implicitly acknowledges the following caveats in the supply-side program:

1. The tax cut has a weak theoretical basis; it stimulates more incremental demand than incremental capacity, at least in the short run.
2. The tax cut may not be perceived as fair to the majority and therefore may not be politically acceptable.

Nevertheless, Dr. Paarlberg recommends that the supply-side economic program be implemented, even though it can't do the whole job. He further refutes pessimism on the limits of growth by observing that technological advance has always come through in the past.

The following reservations are my own. Dr. Paarlberg does not necessarily agree with them, but he characterizes them as "hard questions."

1. The cut in federal expenditures will involve throwing out the baby of investment along with the bathwater of consumption.

2. The funds released are not targeted for investment; they may leak into speculation or consumption.

3. Supply-side economics neglects other plausible explanations of the productivity decline, including:these:

- Short-sighted, salaried corporate managers who lack the entrepreneurial spirit (or who are not permitted to exercise it by short-sighted stockholders) and who therefore concentrated on short-term results and permitted their plans to become obsolete in the 1950s and 1960s.
- Decline of the work ethic, involving both implicit contracts between labor and management, which protect inefficient labor from market pressure, and abuse of recreational drugs ranging from cannabis to television.

The Department of Defense (DOD) is generally exempt from the expenditure cuts because of the urgency of an improved military posture. Nevertheless, because supply-side economics demands a cut in federal consumption, and because most DOD expenditures are consumption, DOD managers are obliged to attain this improved military posture at minimum expense and with maximum beneficial effects on the economy as a whole. This will involve both the application of supply-side economics to the mainstream of defense acquisition and managing the side effects of increased DOD expenditures to amplify the good effects of supply-side economics and perhaps even compensate for its deficiences.

Applying Supply-Side Economics to Defense Acquisition

Of the four tenets of supply-side economics, only the last, reduction of federal government regulations, applies to defense acquisition, but it applies well. A weakness of the federal government is that each time a potential abuse is perceived, a rule designed to correct it is applied to the whole enterprise. The combination of all those rules and reporting requirements leads to paralysis. Victims of over - regulation include not only defense contractors but the DOD itself.

For example, under the Carter Administration, the OMB recognized that information was a valuable commodity and tried to put limits on the amount of information regulating agencies could demand from businesses. But we just as urgently need limits on the information that regulating offices (inside and outside the DOD) can demand from DOD components and from Defense contractors. Such limits would get the job done at lower cost and still permit worldwide reductions in DOD manpower.

Other techniques may be available to increase DOD efficiency. The Navy's Industrial Funding system, which targets appropriations for agents who can select among in-house performing activities, provides motives for efficiency and could be used elsewhere.

Large defense expenditures will inevitably have side effects. The challenge is to make sure that they are beneficial. We currently use procurement policy to support social goods unrelated to or even opposing efficient acquisition, for example, minority small-business set asides and the Davis-Bacon Act. If we accept the spirit of supply-side economics, we should eliminate those features designed to distribute income downward and stimulate consumption, and substitute provisions designed to stimulate investment.

Indeed, if we count on technology to raise the limits of growth and note that many of the revolutionary technologies were born of or fostered by military necessity (transport, computers, integrated circuits), there may be a significant opportunity to institute policies to ensure that DOD will be making long-range investments to ensure the development of new technology, including investments that are too long-term for corporate managers.

The Research, Development, Test and Evaluation (RDT&E) component of a Service budget is generally 10-15 percent of the total, but this percentage is misleading as the bulk of these funds pays for the engineering of specific end items. Investment in the technology base (research, exploratory development, and technology demonstration) is usually on the order of 2 percent of the total. Significant increases in the latter component should be made and would hardly be noticed in the total.

Another form of investment is Independent Research and Development (IR&D), in which defense contractors are permitted to include in their overhead a modest percentage to create a fund for the development of new products and technology. In contrast to direct technology base investment, IR&D investment decisions are made by the contractor and counterbalance errors in the Service's investment strategy. Increased defense product engineering will automatically increase IR&D. Some meddling to ensure that some of the increase goes to long-term investment is probably warranted.

Another long-term investment is the education industry, which expanded, perhaps excessively, in response to Sputnik Fever but is now stagnant. Federal budget cuts directed at the industry are viewed by some as self-serving and unresponsive. Yet education is one of the most valuable and productive long-term national investments.

A possible resolution would be to permit defense contractors to charge for the advanced education of their staff. Thus, DOD would be making a long-term investment in human capital, but the institutions would be chosen not by an educational bureaucracy but by hard-nosed defense contractors.

The past decade has seen a failure of economists to deliver on their promise that they could "fine tune" the economy. Although their models are not in good order, there seems general agreement that policies are needed to encourage investment and that counterproductive government regulations should be reduced.

The DOD is largely exempt from federal expenditure cuts required to release funds for investment. Nevertheless, the DOD should recognize its responsibility to accomplish its mission at minimum cost and to encourage investment that will eventually raise productivity. It can help accomplish the first goal by reducing regulations and the second by reducing its policies supporting social goals and, instead, encouraging (and funding) additional investment in the national technology base.

NASA's Future Under "Supply-Side Economics

Before discussing NASA's prospects in the 1980s under President Reagan's economic policies, we must assess the possible impact of the Administration's supply-side economic formula for recovery. The formula consists of four components:

1. A reduction in federal spending
2. A reduction in income tax
3. A compatible (tight) monetary policy
4. A reduction in federal regulations.

The second and third components will have little or no effect on NASA's future. Consequently, this discussion will concentrate on the first and fourth components.

President Reagan outlined his program in a Presidential message to Congress on February 18, 1981. In that message, "A Program for Economic Recovery," President Reagan indicated that in times of economic stress such as that facing the nation, the federal budget could still continue to carry many programs of national interest, but these programs would not necessarily be accorded the same urgency as before.

He further stated that, overall, NASA's programs would be slightly reduced by trimming back, eliminating, or delaying lower-priority programs, while the essential R&D and Space Shuttle programs would be continued at essentially the previously budgeted levels.

That statement translated into a budget reduction of $604 million, resulting in a revised FY82 budget of $6.122 billion. The budget reduction was accompanied by a mandate to reduce the civilian workforce by 804 (approximately 4 percent), from 22,613 to 21,809.

Generally speaking, the revised budget does the following:

1. preserves the Space Shuttle research, development, and flight test schdule;

2. continues production of a four orbiter fleet on the same schedule as before;

3. maintains an option for a fifth Shuttle orbiter;

4. supports continued development of the Space Telescope;

5. schedules the Galileo mission to Jupiter for a 1985 Shuttle launch using a modified Centaur upper stage;

6. continues support for flight missions such as Voyager that have been launched and are returning valuable scientific data;

7. provides for continued development of Landsat D for launch in 1982;

8. supports preparation for the early years of Shuttle operations at a reduced rate of buildup;

9. eliminates or defers all FY 1981 and 1982 new program initiatives in Space Science, Aeronautics and Aplications;

10. deletes the U.S. Solar Polar spacecraft but supports NASA's commitment to the European Space Agency by providing for a

1986 launch opportunity for a cooperative mission using the ESA spacecraft;

11. makes significant across-the-board cuts in aeronautical and space technology development but retains an effective aerospace research base;

12. deletes planned Construction of Facilities projects including the Transonic Dynamics Tunnel, the Small Engine Component Test Facility, the Mach 19 Nitrogen Tunnel, and a project to reduce energy consumption.

Is this budget a crippling blow to NASA's vitality and future? I think not. NASA has been faced with difficult tasks before and has always found ways to overcome seemingly unsolvable obstacles. To accomplish successfully the remaining programs within the present funding and manpower constraints, NASA must develop new and improved management techniques that will increase productivity. In supply-side economics, the proposed tax reductions are intended to motivate industry to modernize their plants, thereby increasing their productivity. Since NASA is not subject to a tax incentive and since NASA's R&D missions do not, as a rule, require quantity production, contractors are not motivated to modernize their plants for NASA as they would for DOD business.

NASA's opportunity for increased productivity lies mainly in developing new management systems. This concept applies equally to NASA's contractors, who customarily provide only limited numbers (1-5) of specified items under their contracts as opposed to quantity production under DOD contracts. Since NASA and DOD both use to a great extent the same segment of industry to produce their technology, NASA will experience a natural "fall-out" from industry's modernization for DOD's long-production run requirement, thus allowing NASA to reap some of the benefits from the tax relief component of supply-side economics.

Since NASA is not a regulatory agency, the fourth component of the supply-side economics (i.e., reduction of federal regulations) will result in minimal impact on NASA and its contractors.

In summary, while some new and worthwhile programs are being delayed, deleted, or reduced in priority, NASA's important ongoing programs will continue to receive budget and management support. Thus, even though it is not quite what NASA would have opted for, Mr. Reagan's budget will not have a fatal impact on NASA's future.

Agricultural Issues for the 80's in the Economic Picture

Agriculture must be a significant part of any plan to improve the U.S. economy. There are 23 million people employed in agriculture-related jobs (one-fifth of the national labor force). Agriculture accounts for 20 percent of the nation's Gross National Product.

Three areas offer promising opportunities for action that should help stem inflation: (1) commodity payments to producers, (2) productivity, and (3) agricultural exports.

The U.S. has a long history of price supports for many agricultural commodities. Price supports have been defended as necessary to ensure stable production levels and farm income. However, government programs can insulate producers from market forces. This can lead to a slowness in adjusting production levels, less incentive to become more efficient, and prices that are not competitive on the world market. The dairy support program provides a recent example of a support program that is stimulating too much production and becoming too expensive. Support programs should be continued but with frequent adjustments that keep prices more in line with market conditions.

The record of productivity in the agricultural sector has been good. However, more recently there appears to be a leveling off with little or no increase in agricultural productivity. Yield-per-acre appears to have leveled off for some crops and output-per-worker may not be increasing. Mechanization has played an important role in productivity gains for agriculture, but the impact of a strong program of research and development across all phases of agricultural production and marketing has been a strong underlying factor. An increase in prices and in intensity of agricultural research related to productivity is seen as one input for increased productivity for the future.

Agriculture will net a trade surplus of about $30 billion this year, a hugh contribution to the national balance of payments. Continued success in exports is linked to our action in the commodity payments and productivity. How competitive the U.S. becomes in the world marketplace and our capacity to produce adequate supplies for the export market will determine how large our share of this market will be. The attention the U.S. gives to ensuring adequate supplies at competitive world market prices and negotiations for trade agreement will be critical to the success of the U.S. in taking advantage of agricultural exports to strengthen the U.S. economy.

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From left to right: Mildred Thymian, Administrator, USDA/AMS; Chester R. Benjamin, Associate coordinator for International Organization Affairs, USDA/OICD; Ronald Levin, Director, International Agreements and Monitoring Division, U.S. Department of Commerce; Robert Copeland, Director, Office of Health and Disability, U.S. Department of Labor; and Dr. Alan Berman, Director of Research, Naval Research Lab.

IF NOT DETENTE, THEN WHAT?

Robert L. Pfaltzgraff, Jr.

In the United States in recent years there has been a dramatic transformation in outlook toward the Soviet Union. This is based upon several factors which will affect profoundly the American conception of the Soviet Union in the years ahead and the policy options available to the United States in coping with what has been aptly described as "the present danger" posed for the United States by the Soviet Union. To understand the evolution of this changed outlook toward the Soviet Union, it is essential to assess, first and foremost, the apparent differences that emerged between the United States and the Soviet Union in their conceptions of detente in the early to mid-1970s. Furthermore, it is necessary to examine the principal features of Soviet foreign policy during the last decade. Last but not least, crucial to an understanding of the foreign policy problems confronting the United States in its relationship with the Soviet Union in the years just ahead is an assessment of the change in the strategic military balance between the superpowers in the last decade.

The apparent differences in the ways the United States and the Soviet Union have reviewed detente result from the idea that, in retrospect, detente was oversold to the American public and was based upon illusion, even within much of our official policy community in the early to mid-1970s. As we look back upon the last decade, it is evident that the failure of detente, as defined by American policymakers, can be dated from the October War of 1973, which also, incidentally, cast into doubt one of the other central premises upon which American foreign policy in those years had been built, namely, the ability of allies and friends to become surrogates for American power in one or more regions of the world in which the United States was forced by circumstances to reduce its commitments.

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The failure of detente diplomacy is deeply rooted in the American outlook toward the Soviet Union. Three successive Administrations have tried variants of detente diplomacy with the Soviet Union—Nixon's, Ford's, and Carter's—although their conceptions of Soviet-American relations differed substantially from each other. The results of each have been at least less than satisfactory and at most potentially disastrous to the security interests of the United States. The Nixon-Ford-Kissinger approach sought a conception of linkage between Soviet behavior in one category of foreign policy and in another. An attempt was made in the principles of coexistence to which each side agreed in May 1972 to establish a code of conduct for superpowers based on the exercise of unilateral restraint and the avoidance of efforts by either side to gain advantage in regional issues at the expense of the other. The Nixon-Ford-Kissinger approach sought an East-West balance with the Soviet Union by the SALT accords, which codified parity, by normalizing American relations with China and at the same time encouraging the growth of U.S. surrogate powers in various regions of the world. Moreover, Soviet behavior in one category, especially trade, would be linked to Soviet behavior in other categories. The Soviet Union would come, it was hoped, to have a vested interest in detente because of its potential and existing benefits.

The Carter Administration's approach to U.S.-Soviet relations was fraught with paradox, reflecting the apparent split within his own Administration on U.S.-Soviet relations. Carter came to office as a critic of the Nixon-Ford-Kissinger approaches to relations with Moscow. He sought to subordinate U.S.-Soviet relations to other, allegedly more important global issues—those of the Third World. He attempted to align American policy, in the United Nations for example, with Third World aspirations. This idea reached its zenith in President Carter's 1977 Notre Dame Speech: "Being confident of our own future, we are now free of that inordinate fear of communism which once led us to embrace any dictator who joined us in that fear. I am glad that's being changed." At the same time, Mr. Carter sought to make human rights a central element in U.S.-Soviet relations, together with the achievement of arms limitation agreements—the SALT. He held to a belief that unilateral restraint on the part of the United States would produce reciprocal action on the part of the Soviet Union. Perhaps even more than the Nixon-Ford-Kissinger policy, Carter's efforts were failures and were perceived as failures by a growing number of his countrymen and eventually by most of those who voted in the election of 1980. Toward the end of his Administration, and particularly after the Soviet invasion of Afghanistan in December 1979, there were important manifestations of a changing outlook on his part—in particular, the withdrawal of the SALT II Treaty from Senate consideration —although Carter had promised in the Presidential campaign to resubmit the Treaty to the Senate if he was reelected. Here it is doubtful that the SALT II Treaty would have achieved Senate ratification even before the Soviet invasion of Afghanistan. It probably would have been ratified only if it were linked with vast increases in American defense capabilities to cope with the growing challenge posed by the Soviet Union as a result of its military buildup in the 1970s.

These successive failures in American efforts to bring about an improved relationship with the Soviet Union set the stage for the debate that erupted in the United States in the late 1970s, both about the nature of the American role in the context of U.S. national interests and the implications of the growth of Soviet strategic military power for the security of the United States and its allies. Of major importance in this debate was the repeated evidence of a fundamental difference between the American and Soviet approaches to regional stability or instability. It may be argued that Kissinger had understood the nature of the Soviet Union as what he termed an imperial power, a state in the imperial phase of its history and behaving much as such states could be expected to behave in their international relationships. Although, or because, the American willingness to devote adequate resources to national security and to foreign policy had apparently declined in the post-Vietnam period, it was essential for the United States to call upon whatever restraints existed to contain Soviet power. This was the context in which the United States made repeated efforts to call into being, as if it were possible to do so, a global system of several power centers. The United States was engaged in a holding action until a new consensus could emerge in support of a more activist, internationalist and effective foreign policy.

If this was the case, the effect of U.S. policies of the early 1970s was to produce unwarranted expectations of immediate success—a generation of peace or a new structure for global peace, as the terms were widely used—although by the end of the 1970s the United States had begun to enter yet a new phase in its foreign policy. It was the widening gap between American expectations and Soviet policy—in Angola, Yemen, Somolia, Ethiopia, Southeast Asia, and finally Afghanistan—that produced the ***coup de grace*** for the Soviet-American relationship in the 1970s and the assumptions on which it was based. The evidence mounted that Moscow held to a conception of detente, acknowledged by the Soviet leadership itself, in which periodic improvements in relations with the United States in no way diminished the need for a continued struggle against Western imperialism. Whereas we had perceived detente often as an end in itself, a condition of peace and global stability, the realization grew in the United States that for the Soviet Union detente was a process, or means, toward an end—that struggle, not stability, was inherent in international political relationships.

By the end of the 1970s we had come full circle, from a conception of containment in a generation after World World II that rested on a broadly based bipartisan consensus until the Vietnam War, but which was shattered until the mid to late 1970s, and which has begun to be restored as a new nationalism (some would say neo-conservatism) massively demonstrated in the election of 1980.

Of perhaps equal importance to the changed U.S.-Soviet relations was the dawning realization in the strategic military affairs community of the United States that fundamental differences existed between the superpowers in their conceptions of strategic stability and of military doctrine. Translations of Soviet literature and the study of Soviet military concepts yielded abundant evidence that the Soviet Union placed emphasis on concepts of surprise and pre-emption, as well as the integration into a doctrinal framework of strategic offense and strategic defense. Deterrence in a strategic-military sense had different force level requirements in the Soviet Union than in the United States. If nuclear was unthinkable in the United States, the Soviet Union was working on means to survive it. The recognition of such asymmetries in Soviet and American doctrine led to a belief that American conceptions of strategic doctrine, grounded in mutual destruction, were inadequate in a strategic relationship in which one's adversary held to a fundamentally different conception of deterrence and of the potential role accorded to strategic military power in support of political objectives.

With a growing appreciation of difference between the doctrines espoused by the Soviet leaders and those of the United States, it was only logical to relate such statements to strategic nuclear force levels and to the trends manifest in the Soviet strategic force program. If Soviet doctrine stressed preemption and surprise, together with the survivability of the Soviet Union in the event of nuclear war—emminently sound military concepts and objectives—there was mounting evidence of Soviet strategic programs in keeping with such concepts. The Soviet air defense and civil defense programs, about which there was controversy in the United States related more to their extent and effectiveness than to their existence, were cited in support of Soviet doctrine. In contrast, the United States, perhaps in keeping with the concept of mutual assured destruction, had in effect abandoned air defense after about 1970. Similarly, Moscow's deployment of several fourth-generation ICBM launchers, the hardening of launch sites and facilities for elites, the deployment of ICBMs with throw-weight and accuracy potentially capable of destroying all or a major portion of the U.S. Minuteman force, gave evidence of a relationship between Soviet strategic doctrine and the force levels that were being developed and deployed in its support.

Such was the context within which the SALT II Treaty debate took place in the United States. The American approach to SALT had been premised upon the mutual assured destruction doctrine (MAD) of the United States. Those who rejected MAD usually had serious reservations about a SALT II Treaty, which appeared only to codify a strategic military balance that was tilting ominously away from the United States. The split in the American strategic military affairs community between proponents of MAD and those who emphasized a much stronger defense posture based on counterforce was in part a division between proponents and opponents of the SALT II Treaty. A third approach may be noted—it was argued that the Treaty did not reduce substantially the strategic forces of either side and therefore could not be said to constitute genuine arms control. It was such dissension that ultimately helped defeat the SALT II Treaty. But the debate on the SALT II Treaty was really a debate about U.S.-Soviet relations, past, present and prospective. Critics of the Treaty argued that in the decade of SALT the Soviet Union had achieved, with the United States, not only parity but an increasing measure of superiority in most categories of strategic forces. In the decade of SALT, the Minuteman vulnerability problem had grown. The Interim Agreement on Offensive Systems signed in 1972 had conceded the Soviet Union a quantitative edge in ICBM launchers, while the SALT process since 1972 had done little, if anything, to restrain a qualitative Soviet improvement. In short, SALT had been perceived increasingly to be a kind of strategic *cul-de-sac* for the United States. Clearly, with or without SALT, we would face the need for major new strategic programs in the 1980s if we were to counter the Soviet buildup. Opponents rested their case on the fact that the Treaty codified a superpower strategic military relationship grossly disadvantageous to the United States. Proponents were often able only to argue that, without the Treaty, the United States would be even worse off because the balance would tilt even further away from the United States. The recourse, both came to agree in principle, lay in American modernization programs designed to rectify perceived deficiencies in the U.S. military force posture.

In retrospect, it may be argued that just as the United States expected too much from a detente relationship with the Soviet Union, it placed excessive hopes in SALT and in arms control generally. By the early 1980s, the dominant view had come to be that arms control policy would be no substitute for an adequate strategic doctrine or for effective defense modernization programs in the United States. Thus the election of 1980 symbolized, in foreign policy, the rejection of a large number of assumptions of the 1970s about U.S.-Soviet relations, including the previously fashionable view that military power, relative to other instruments of statecraft in foreign policy, was of little importance to the United States.

What then are the prospects for U.S.-Soviet relations in the 1980s? Much American analysis in recent years has focused on the phenomenon of "window of vulnerability" for the United States, which translates into a "window of opportunity" for the Soviet Union.

The extent to which the Soviet Union presses whatever advantages may be said to accrue to it in the years just ahead will determine the nature and extent of stability or instability in the Soviet-American relationship. Will the Soviet Union seek to exploit U.S. vulnerabilities during a period in which the United States is rebuilding its military capabilities? Will the Soviet Union engage the United States in crisis diplomacy in which Moscow's advantages will be substantial at progressively higher rungs in a hypothesized escalatory ladder—in a Cuban-missile-crisis-in-reverse scenario. In that crisis the United States held both local and regional conventional superiority and strategic-nuclear superiority. While the Soviet Union enjoyed military advantages in certain other crises, as in the successive tests of Western will in Berlin, the United States was superior at the strategic-nuclear level. As a result of trends in the last decade, we face the prospect of inferiority at both levels until and unless basic changes are made in our overall defense posture.

Although many in the United States initially viewed without alarm the growth of Soviet military capabilities, even seeing them as contributing to stability, since Moscow presumably would be more inclined to negotiate arms ceilings once it had attained parity with the United States, the question now arises whether the Soviet Union can be expected to acquiesce in American efforts to narrow or eliminate a military gap favoring the Soviet Union. The ability to answer that question would enhance our understanding of the prospects for the U.S.-Soviet relationship in the years just ahead. Unless the Soviet Union had come to embrace American conceptions of deterrence, strategic stability, arms control, and the presumed disutility of military power in the late twentieth century, there would be little reason to expect Moscow to behave toward the United States as the United States did toward the Soviet Union while Moscow was narrowing the gap.

Perhaps evidence of resolve and of strengthened national will on the part of the United States, seen in sharp contrast to the vacillation in American policy of recent years, will provide the ***deus ex machine*** sufficient to deter the Soviet Union from exploiting whatever advantage may be perceived to accrue from the vast capabilities accumulated during the last decade. It is conceivable that the United States will thus transform weakness into strength even in the absence of sufficient military capabilities. But it is equally plausible that the Soviet Union will assess the correlation of forces as being maximally to its favor just before or precisely at the time that the United States ***begins*** to narrow the gap in military capabilities. In this event, the point of maximum danger in international crisis to the United States would seem to lie in the years just ahead. The approximate time of such a period of maximum danger depends upon whether the military advantage favoring the Soviet Union widens before it narrows, and when or whether it is transformed from the edge enjoyed by the Soviet Union to a "margin of safety" for the United States.

To be sure, the Soviet Union faces numerous vulnerabilities both during and after its period of maximum opportunity. It is conceivable that its formidable problems in Poland will deepen and spread and that repression by Moscow will meet with resistence. The prospect exists that the vulnerabilities of today will be magnified for the Soviet Union in the next decade or generation. These include declining productivity and an aging population as a result of demographic trends, nationalities problems, repeated failures in agriculture and in the nonmilitary-industrial sector, and problems of reliability often noted in the forces of the Warsaw Pact and underscored by events in Poland. If such problems can be expected to create growing vulnerabilities for the Soviet Union in the next decade, does this not reinforce the notion that the maximum opportunities available to Moscow will fall within the next several years?

What then are the policy options available to the United States in fashioning a global strategy in the years ahead? It is possible that the communication of national resolve by the United States to its principal adversary will elicit deference even in the absence of requisite strength, and that such signals will deter the Soviet Union from miscalculation in its relationship with the United States. But it can be argued that without the substance of power the United States risks a humiliating situation in which Moscow calls its bluff. Would it not be preferable for the United States to acquiesce in Soviet probes until American power is reconstituted? If the United States faces the specter of a Cuban-missile-crisis-in-reverse, would it not be less damaging to American interests and prestige to avoid by whatever means possible a confrontation with the Soviet Union in the next several years? To answer such questions in the affirmative is to embrace a policy of appeasement based on weakness and to acknowledge the implications of the failure of American detente policy toward the Soviet Union for at least the past decade.

To adopt such an approach is to assume, furthermore, that the United States necessarily has the luxury of choosing between defending its interests with whatever means may be available or accommodating, if only temporarily and tactically, the superior power and designs of the Soviet Union. Although such choices are theoretically available, they confront in the real world vital interests for which such compromise based upon expediency may be impossible because of the vital interests at stake. The most obvious example can be found in a hypothetically destabilized Saudi Arabia in which the Soviet Union becomes, or threatens to become, the dominant influence, with attendant consequences for Western Europe, Japan and the United States.

In keeping with the notion of a world of diffused economic power, the United States can try to achieve a more equitable sharing of the burdens of international security with its allies, notably with Western Europe and Japan. Although there remain substantial differences between the United States and its allies stemming from their interests and relations with the Soviet Union (e.g., West German trade with the Soviet Union and the tangible benefits flowing from intra-German normalization), the United States will seek from its allies a fair share of defense both within their immediate regions and perhaps, although to a lesser extent, outside. Central to its strategy in the late twentieth century is the preservation of alliances. Although the power and the threat of the Soviet Union have grown, the United States faces, especially in Western Europe, allies whose policies are conditioned by domestic constituencies and constraints. These constraints lead governments to policies different from what the United States, in this new phase of American policy, is likely to consider adequate. In the years ahead, moreover, the Soviet Union can be expected to maintain its efforts to reinforce such tendencies as a means of encouraging what has been termed the Finlandization, or perhaps the Hollandization, of Western Europe. Soviet policy will be designed to strengthen those forces opposed to needed NATO modernization, including the deployment of long-range theater nuclear systems.

Such forces have achieved momentum in important constituencies in Western Europe. In some respects, however, their perspectives have not been at odds with the policy of the United States until recently. For more than a decade, successive American administrations urged upon our allies policies of detente and support for strategic arms control. SALT was initially an American, not a European, idea, although its most fervent supporters in the official policy community are now to be found not in the United States but in Western Europe. Just as present European perspectives are the products of forces shaped over at least a several-year period, policies of consistency and strength manifested by the United States will help to strengthen those among our allies who hold a common appreciation of the dangers confronting us. Such a change, however, will not come overnight. Thus if there is a lack of policy synchronization between the United States and its allies, its causes lie not only in our allies' quest for greater independence, but also in American policies of the past decade now discarded in the official American policy community but still deeply rooted in the prevailing orthodoxy of certain elites abroad.

Of equal importance to the United States is the preservation, and to the extent necessary, the strengthening of relations with allies and friendly states in East Asia. In that region we have seen the evolution of a security framework over the last decade which contains as principal actors the Soviet Union, Japan, and China, in addition to the United States. This security system has been described as quadrilateral in its key actor membership, although it affects, and is affected by, relationships among lesser states, notably the two Koreas. It is asymmetrical as a result of the vast differences among its members in the major categories of military and economic strength. Only the United States possesses relatively balanced capabilities encompassing both the military and economic sinews of power. Over the last decade, whatever interests existed among at least some of the major actors to follow a policy of equalibrium with respect to the other members of the system—notably with China and the Soviet Union—have been replaced by a policy, especially in the case of the United States, of *de facto* alignment with China against the Soviet Union, and in the case of Japan a quest for rapidly expanding trade with China. (Of course, the future of

Japan's economic relationships with China now seems less certain because of the apparent setbacks in the four modernizations in China and the apparent continuation of a power struggle within the PRC.)

The security framework that has evolved in East Asia over the last decade has been set, of course, within the broader global strategic framework outlined earlier. That is to say, the manifest growth of Soviet military power, the outward thrust of Soviet policy into the littorals of the Indian Ocean, and the marked deterioration in relations between Moscow and Washington have deeply influenced alignment patterns in East Asia and can be expected to continue to do so in the years just ahead. Hence, elements of a classical balance of power model serve as useful reference points for analyzing regional security at a macrocosmic level.

In this respect the United States and China have evolved a series of parallel interests, together with a common appreciation of the threats posed by the Soviet Union. As the momentum of Soviet efforts in military modernization and its willingness to make direct or indirect use of such power politically, the American relationship with China changed from a framework based on equilibrium, or equidistance, to one providing for alignment, but not formal alliance, with China against the Soviet Union. By 1981 the ultimate extent of an American alignment with the PRC against the Soviet Union remained undecided; however, the scope of that relationship will be determined in the future, as historically it has been for other nations, by perceived dangers emanating from the Soviet Union. In the United States the assertion of a new nationalism, or a neoconservatism, in foreign policy based on the recognition that the principal threat stems from the Soviet Union coincided with the same strategic assessment in Beijing. This PRC assessment included China's assertion that the Soviet Union was, and is, pursuing a two-pronged strategy in which pressure is applied to the West against NATO and to the East against China and Japan. China contributes to the contemporary regional and global security system by holding on her western frontier approximately one-quarter of Soviet military strength. To the East and to the West, the Soviet Union has been effectively contained by China and by NATO. Therefore, the Soviet Union has pushed southward into regions adjacent to the strategically vital Persian Gulf and into the oceans, in an effort to outflank Western Europe and to encircle China. This so-called two-pronged Soviet strategy, to which Chinese spokesmen have frequently referred in recent years, is worth outlining here because it represents in a growing consensus among American analysts an accurate assessment of Soviet strategy. Thus we may speak of parallel Sino-American interests in Soviet containment based on a common strategic appreciation which, nevertheless, does not necessarily translate into identical policies.

Although China's and Japan's security perspectives in and beyond East Asia differ substantially, there has been a considerable change in the Japanese outlook on regional and international security issues in recent years. This results from four principal factors: the Soviet invasion of Afghanistan, the strengthening by the Soviet Union of its military forces in the northern territories seized from Japan at the end of the Second World War, the sustained maritime buildup by the Soviet Union in the seas adjacent to Japan at a time when the United States had drawn down its forces because of security interests in the Indian Ocean-Persian Gulf, and the threats posed to energy in the Persian Gulf region upon which Japan is so vitally dependent. As a result, Japan and the United States seem to be reaching a consensus on international security to an extent hardly imaginable even a few years ago. Japan's cosmetic consensus, however, is not yet sufficiently strong to support what the United States, and even some in Japan, would like to see Japan bear as a fair share of the security burden in the Western Pacific. Once again, as in the case of the European-American relationship, there is a lack of synchronization between Japanese and American policies, reflecting the interests of different constituencies.

What will be needed in the Japanese-American relationship in the years ahead will be a conception of comprehensive security in which Japan can play a somewhat greater maritime defense role in the Western Pacific and a larger economic role outside the region. As with alliance relations elsewhere, U.S. cooperation with Japan will call for a sophisticated combination of American leadership and consultation, together with a continuing American-Japanese assessment of the global and regional security environment, leading to an appropriate division of labor based upon more adequate force levels from both Japan and the United States.

But the principal conflict arena, it is widely assumed, lies not in Western Europe or in East Asia, but in the Southern Hemisphere, in politically unstable Third World countries, some of which are important producers of minerals upon which the United States and its allies depend. Although much attention has been focused on the Persian Gulf, the potential for instability and for conflict elsewhere is abundant. The causes of such conflict can be found in local social, economic, and political circumstances, in the upheavals that have followed the end of Western empires in such regions, and in the arming of revolutionary groups by outside powers, especially the Soviet Union and Moscow's use of surrogate forces from Cuba. A decade ago the United States sought unsuccessfully to reach agreement with the Soviet Union that neither superpower would exploit such instability for unilateral advantage. In the 1980s the United States faces the immediate need to halt Soviet-Cuban arms transfers to such groups and to take other steps designed to prevent forces compatible with American interests from being overwhelmed by Soviet-Cuban supported groups. In large part, this is the meaning of American policy in El Salvador set in a broader strategic context.

Thus the alternative to a discredited conception of detente is the pursuit by the United States of policies designed, first and foremost, to maintain and build coalitions of strength in support of vital interests while undertaking necessary defense modernization programs. This means, for the United States, steps to strengthen each of the legs of the triad of strategic forces and to increase their survivability in light of present or emerging asymmetries favoring the Soviet Union. Defense modernization necessarily encompasses general purpose forces as well as strategic nuclear capabilities. It includes the modernization of maritime forces as well as the development of a rapid deployment capability and the refurbishing of reserve forces. It means consideration both of the nature of future conflict and the creation of adequate doctrines and strategies, together with correction of deficiencies in the American defense mobilization base both in its industrial infrastructure and in manpower-personnel dimensions.

Last but not least, the policy of the United States toward the Soviet Union must be set within a framework which has military as well as political-economic dimensions. Burden-sharing with allies should encompass the concept of a fair share for each ally in defense, but it should also contain the notion that alliance partners contribute to the sharing of nonmilitary burdens as well—what in Japan has been termed comprehensive security. The alternative to detente, moreover, must seek to exploit existing and emerging Soviet vulnerabilities—to turn the Soviet Union inward to cope with its own formidable problems and thus to relieve outward pressures by Moscow upon the United States and its allies. To set forth such basic guidelines for American policy toward the Soviet Union is to acknowledge the existence of risks, especially in a period of maximum Soviet military power. However, to fail to take such steps would pose even greater risks for the United States and other peoples whose security will depend ultimately upon the strength and clarity of purpose of the United States in the years ahead.

Commentary on Foreign Policy

After World War II, the U.S. adopted a policy of containment of Soviet expansion, a policy that in time had both successes and failures. But the war in Vietnam weakened domestic resolve for military opposition to communist aggression. This change of heart led to a policy of detente, which most Americans considered a way of reaching an accommodation with the Soviets. It was clearly based on the assumption that the Soviets would halt their expansionism if we enlarged our trade with them, limited our arms development and procurement, accepted Soviet hegemony where it existed, and otherwise backed away from confronting the USSR. It now seems clear that the Soviets never had the same perception of detente that we had; they have not acted as though detente posed any barrier to their expansionism or arms build-up.

If one believes, as we do, that the Soviets remain committed to global domination, then one must assess the threat the Soviets pose to the U.S. and the rest of the world. This threat is composed of three major elements.

First of all, the Soviets have a clear superiority over the U.S. in both strategic and conventional military capability. This superiority not only exists quantitatively, but may also exist qualitatively, particularly in some weapons categories. Their strategic threat is intensified by policies that assume that the Soviet Union would make the first strike, enjoy a grossly superior edge after it, and have more weapons left even if we had the will to retaliate with what is left us after the first strike. The Soviets obviously have much greater conventional forces and can now project them virtually anywhere they want. Their projection capability exceeds our own, at least in such vitally important areas as the Persian Gulf and the Horn of Africa. And it will take many years for the U.S. (or any other nation) to develop and deploy new weapons in sufficient numbers to close the gap.

Second, our allies in Western Europe are moving towards their own accommodation with the Soviets. In part this stems from a growing dependence on East-West trade (the West seems to be more dependent than the East, at least politically), a mistrust of the U.S.'s capability and willingness to help Europe, the fear that Europe would suffer as much as or more than anyone else in a nuclear war, their vulnerability in resources such as energy, and their feeling that perhaps Finlandization is not so bad. In short, our allies, with their own economic and social problems, are becoming less and less willing to spend more on arms or to curtail East-West trade in a way that would put pressure on the Comecon nations. Japan is in much the same position, though Soviet occupation of former Japanese islands (e.g., North Sakhalin) reduces the likelihood of a Russo-Japanese accommodation.

Finally, the Third World is the area easiest for the Soviets to penetrate. While there are exceptions, the standard of living in most of these countries is extremely low and is getting even worse in relation to that of most Northern nations. Some form of socialistic economy appears to be more attractive to them than capitalism, an attraction that results in a conceptual friendliness with Moscow. In many cases, our allies do not seem to feel that there is any real threat from the Soviets. Moreover, with Soviet successes in every part of the globe, indigenous communist movements can and do receive direct aid from their neighbors in states such as Vietnam, Ethiopia, and Cuba.

The result of this threat is that the Soviets now have what has been termed a "window of opportunity" to expand their influence. Conversely, the U.S. is said to have a "window of vulnerability" that grows wider as Soviet military superiority increases. Moreover, trying to defend the status quo everywhere, which obviously can be very unpopular in some countries, is inherently much more difficult than the Soviet foreign policy of destabilizing any situation outside of its world that it can. The Soviet window of opportunity will be at its widest just at the moment when the U.S. decides to re-arm but has not yet been able to increase significantly its deployed forces.

Given the nature of the threat, the question becomes, What can and should the U.S. try to do about it? The objective is clearly to reach some form of accommodation with the Soviets. Should this accommodation be achieved through some form of (self-) Finlandization, through some form of detente, or through a rebuilding of U.S. strength that would allow greater leverage in any negotiations or confrontations with the Soviets? If the latter route is taken, there remains the question, What should the U.S. do while its window of vulnerability is most widely open? For example, what should the U.S. do in the event of a Soviet-sponsored Baluchi war of independence which threatens the Straits of Hormuz?

The U.S. appears to have only two real choices: It can accede (at different paces) to further extensions of Soviet power and the resulting reductions in the independence of the U.S. and other states, or it can attempt to regain sufficient military power to confront the Soviets in those areas most sensitive to our national interest (which could be any area not currently in the hands of the Soviets or their proxies). While conceding that the Finlandization of the U.S. might not be that bad—even that it may be inevitable—we strongly recommend that the President take the other course and adopt a policy of confronting the Soviets' expansionist moves with sufficient power, including military power, to deter them. Specific actions that we feel should be pursued include the following:

1. Since the only area in which the Soviets have real superiority over the U.S. is military, the starting place for relieving the pressure is to build up the West's strategic and conventional weapons. But how, given the current Soviet superiority, should this build-up take place?

2. While the allies, particularly Japan, may be willing to devote more to their military forces (and this should be encouraged), the U.S. should not count on assistance in any ally's confrontation in which its homeland is not directly threatened.

3. A greater conventional military force would ensure the quick deployment of large numbers of trained forces, including logistical support and tactical air power. At some point, the U.S. needs to admit that the all-volunteer army is a failure in providing the number and quality of its personnel. In short, the resumption of the draft and the maintenance of reserves at a higher level of capability are needed. Other needed steps include the strengthening of air and naval support units and the ability to protect them, the development of a new generation of hand-held missile-type weapons that

do not expose the users to great danger, and the development of extremely simple weapon systems that can be used quickly and effectively by unsophisticated forces such as local guerrilla groups in Afghanistan.

How should we reduce the time it takes to develop a new weapon system? Of particular interest is the development of a sufficient, in-being industrial capacity to produce the most important weapon systems and the strategic resource reserves from which to make the weapons.

How do we get out of the post-war military thinking that stifles the procurement of weapon systems? Evidence suggests that the two things that have scared the Soviets the most in recent years are the cruise missile and the ability of the U.S. to go into space and recover whatever it wants. There are undoubtedly analogous weapons systems for conventional warfare that could be developed to overcome the numerical superiority of the Soviets in such areas as tanks and and tanks may look good by the standards of past wars but may be inefficient and ineffective in offsetting the Soviet threat. In this area we need more open debate on survival capability and more cooperation with our allies in developing technology.

We must decide what percent of GNP is appropriate for rebuilding the military. Perhaps the job could be done relatively cheaply if the right weapons systems were chosen to go with greater and better manpower. On the other hand, adding $50 billion a year may be worthless if it is spent outproducing the Soviets in tanks or paying draftees more.

We must be willing to supply other nations or factions within nations with military and economic help in countering threats by the Soviets or their proxies. This will, of course, stretch our production budget and may up the percent of GNP devoted directly to confronting the Soviet threat. But it should also reduce the per-copy costs, gain some return of trade dollars (e.g., from OPEC countries), and allow the testing of military equipment by others.

An important question is whether the U.S. will ever be credible in international defense until it once again shows a willingness to have its troops bloodied in some kind of conflict. Obviously, it would not be to our advantage to commit ourselves to another conflict like Vietnam, in which the logistics and other odds were stacked against us. Yet the legacy of the Vietnam war is such that even if U.S. public opinon has shifted to the point at which the public would support at least limited military intervention, neither the Soviets nor our (potential) allies may perceive the shift.

We must use trade more effectively as a weapon. Trade with the Soviets and their satellites by the U.S. and allied nations may help Western economies, but, at the same time, it allows the Soviets to devote their resources more fully to increasing their military might. Moreover, to the extent that this trade transfers technology to the Soviets or increases Europe's dependence on the Soviets for energy, it strengthens the Soviets vis-a-vis the West. This is not the classical economics classroom prespription for free trade, of course, but rather a recognition that the Soviets' gains from trade can translate into military and political power that is greatly to our disadvantage.

How can we most effectively sue our agricultural products to our advantage? The USSR has done a terrible job in handling its agricultural problems, and Eastern Europe has the same kind of problems. But holding back on agricultural trade with the Soviets often creates disproportionate hardships on our agricultural sector. Furthermore, when the U.S. constrains the shipment of agricultural products, the Soviets can rucoup some of the loss from other sources, albeit often at higher prices. In short, we need to find a mechanism, which might require greater federal intervention than free market economists are willing to tolerate under normal conditions, to assure as much damage to the Soviet economy as possible when it embarks upon an expanionist venture.

Our allies have shown a remarkable willingness to offset any reductions we may make in trade with the Soviets by increases in their own. Moreover, they assume that the GATT agreements give them every right of access to our markets despite these actions and despite their unwillingness to spend an appropriate amount of their GNP on military defense. Again, despite the protestations of free market economists, some strings should be attached to free trade with our allies to encourage them to reinforce rather than negate whatever trade policies we decide are appropriate for the Soviets.

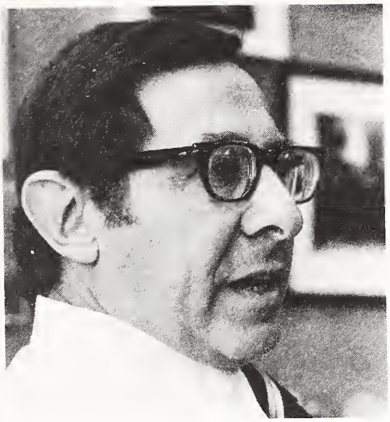
4. The Soviets have political and social weaknesses as well as economic ones. If we are to divert them from external expansionist

tendencies, then one way is to force them to pay more attention to some of these internal social and political problems. The most obvious example is Poland. From a strictly Machiavellian point of view, the best outcome for the U.S. would be a Soviet invasion of Poland. This would have some impact on the so-called nonaligned nations, would divert Soviet military forces from other targets, and would probably have major impact in Europe; the West would become more wary and more willing to sacrifice while the East would suffer economic dislocations. (Poland is a key to the distribution of the production functioning of Comecon.)

We must also continue to exploit the schism between Moscow and Beijing. The Chinese are reportedly tying up about 25 percent of the Soviets' military forces already. While there are dangers in tying ourselves too closely to China, it is certainly in the U.S.'s interest to do whatever it can to ensure that China remains an antagonist of Moscow. If possible, it may also be useful to consider using China as a conduit for the supplying of arms to groups resisting Soviet expansion, especially in Afghanistan and possible in Pakistan should the latter (with Iran) ever be threatened by a Soviet-sponsored Baluchi freedom movement.

The U.S. must also decide how best to minimize the possibilities of communist-sponsored insurrections in a variety of Third World states. Past methods have included direct and indirect economic and military aid, the sponsoring of U.S. proxy nations, and reliance on the U.N. While none of these methods has proven particularly effective in all situations, each has a place, and the U.S. should consider how it can best use its allies in the Third World. Nations such as Brazil, Nigeria, Iraq, India, and Mexico are of extreme importance to the U.S. With the exception of India, they have all made considerable economic progress. They generally have both the land and population sufficient to be major regional power influences if they so choose. We must manipulate aid and trade with these nations in such a way as to encourage them to be our proxies in resisting Soviet expansion in their areas. This means that they should be encouraged to oppose local Soviet proxies. For example, we should do what we can to make Mexico and Cuba become antagonists or competitors rather than partners in denouncing the U.S. in the U.N. or elsewhere.

Finally, with regard to Third World states, there are two things we should avoid doing. First, the U.S. should not make nuclear weapons in any way a condition for aid or trade. While further proliferation of such weapons is undesirable, we can at best hope to slow down the process. And in trying to manipulate their development of nuclear weapons, we are more likely than not to reduce our ability to influence those states in taking other actions far more relevant to the containment of Soviet expansion. Second, we should espouse human rights but not to the point that all hope for them gets lost as the Soviets take over the country. In short, while it may make us look hypocritical at home and abroad, our support of noncommunist governments, even if they abuse human rights we endorse, may be preferable to leaving states open to Soviet takeovers.



ROBERT A. GOLDWIN

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From left to right: Richard Heifner, Staff Economist, USDA/AMS; Dr. Francis T. Holt, Environmental Specialist, USDA/Soil Conservation Service; and Allen Hidlebaugh, Soil Scientist, USDA/Soil Conservation service. *Not in picture:* Richard DeHaan, Chief, System Policy and Planning Group, Department of Justice; and Shirley A. Evans, Acting Deputy Director, Office of Finance and Accounting, Department of Housing and Urban Development.

OF MEN AND ANGELS: A SEARCH FOR MORALITY IN THE CONSTITUTION*

Robert A. Goldwin

Do not be misled by the theological tone of the title of this essay. Despite the reference to angels, and despite the unlikelihood that any serious political inquiry can progress very far without encountering theological questions, it is my intention to present my argument in terms wholly secular, or at least as secular as political discourse can be.

The title speaks of men and angels, and doesn't mention women. As you shall see, the title refers to a sentence in ***The Federalist***, the great commentary on the proposed Constitution written in 1787, principally by James Madison and Alexander Hamilton, under the pen name Publius: "If men were angels, no government would be necessary." I cannot, of course, take liberties with a famous sentence from a Great Book, but one should think that women are being excluded. Publius would surely have conceded the full equality of women, as I do, in this respect, and in very many others, and would have agreed that women, every bit as much as men, are not angels.

Another caution: I read the sentence "If men were angels, no government would be necessary" as two linked assertions: one, that men are not angels, and, two, that government is necessary. I know, and I point out to the reader, that the sentence does not say that in so many words.

A final caution: I mean very seriously, as the subtitle indicates, that this essay is meant to be a search. What I am searching for is morality in the American constitution. Immediately three questions present themselves:

1. Why do we have to look for it?
2. What is meant by the constitution?
3. What morality is possible and appropriate for America?

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Why must we look for and worry about morality in the constitution? For two good reasons. First, because so many immoral actions have besmirched our behavior in the recent past. We have had assassinations, Watergate, tawdry congressional sex scandals, corporation bribery on a worldwide scale, labor union murders, grain inspection frauds, mishandling of receipts of food stamps, cheating by medical laboratories, scandals in the management of guaranteed student loans, and so on and on in a seemingly endless list that convinces many that no part of the American community is uncorrupted, that immorality is ingrained in us as a national trait, that we are hopelessly immoral. That is one reason for searching for morality in the constitution.

A second reason is that we are a morally judging people who make moral judgments all the time. Sometimes we judge ourselves much too high and sometimes much too low. For example, wartime rhetoric made it seem that we had no selfish national interests in the world wars and their aftermaths, that unlike every other nation, including our allies, we fought for altruistic and idealistic reasons only.

But when we are not judging ourselves too generously, we are often very severe, some would say too severe, on ourselves. During the two years of the Watergate revelations, Europeans were confused by what they called our naive reaction to government behavior that they considered just what one must expect of government officials anywhere. One intelligent and thoughtful Englishwoman told me that the American public's reaction to Watergate revelations confirmed what she had long believed about Americans, that we suffer from "moral greed." Europeans generally thought we were denigrating ourselves excessively. Even now, when the facts are known, dismal as they are, many still think so.

The fact of civil doing and the discovery of it, and our unfailing national shock, and the widespread, vehement, public condemnation that follows, are evidence of two equally significant points: not only that we are capable of immorality, that is, that we are not angels, but also that we set very demanding moral standards of political behavior, approaching the angelic, and truly expect and demand politicians and other leaders to live up to them.

I belabor this duality because it is very important for the survival of political liberty and decency in the world that we Americans have a true appraisal of ourselves. In national matters, as in personal matters, to know yourself is as important to survival as it is happiness. And to know yourself, as we all learn from study and from experience, is one of the most difficult tasks men and women face in life. If we do not know ourselves and hence judge ourselves by inappropriate standards, all kinds of false judgments result, too lenient or too harsh, but just right only rarely—and then only by accident.

The national danger is that by condemning ourselves or excusing ourselves unjustly, that is, by false standards, we will weaken the very forces in the world that are almost alone capable of upholding the principles of decency we love and seek to live by.

Americans are moral judgers, and severe judgers at that. More, we judge no one as severely as ourselves. This may not always have been the mass phenomenon that is it today, but elements of it have always been present in us.

That does not mean that we always, or even regularly, do the right or good thing. It means that when we do not, or when we do the wrong or evil thing, for whatever reasons of necessity, or convenience, or advantage, or whim, or passion, or ignorance, there are almost always, and almost always promptly, voices raised in self-criticism and self-condemnation. And those morally condemning voices have listeners.

Moral principle has weight and force in American political discourse. Even if we assume—as we must assume if we remember that men and women are not angels—that people act in politics primarily in pursuit of interests that are advantageous to them, and usually not advantageous, or even disadvantageous to others, nevertheless, in America individuals and groups are greatly strengthened if they can connect their cause to moral principles. And if that connection is a true one, and if decent, disinterested people can see that connection readily, the case is strengthened even more, even to the extent that supporters will be enlisted whose interests might otherwise not make them allies, or might otherwise even make them opponents.

One massive example comes readily to mind, and that is the great civil rights movement of the fifties and, especially, the sixties. The principles of justice and equality had been available for generations to all American interest groups seeking to pursue their own advantage through political action. The fact that individual leaders like

Martin Luther King and interest groups like the NAACP and CORE and the Urban League could add to their otherwise insufficient political strength by connecting themselves, not only in words but in concerted actions, to the most powerful moral principles of the American polity added to their strength fivefold, and more.

This combining of noble principle and self-interest, a foundation of American politics, is not hypocrisy, in my judgement. To show that black citizens gained material advantages by the legislation and court orders they obtained through moral arguments does not, I think, demean or debase the principles; it ennobles the interests. That is one way to understand Tocqueville's phrase "self-interest rightly understood"—that it is possible for selfishness to be ennobled, if not sanctified.

So seriously do Americans take morality, so politically powerful are the principles of justice and equality, that no policy, domestic or foreign, political or economic or military, can be successful, can get support, can be sustained, can survive setbacks, that does not have a clear and acceptable moral content, visible and meaningful to the Congress, the press, and above all to the American people. No matter how adroitly scheming, calculating, and self-serving individuals or groups may be, unless their suggested policies can be clothed in fitting moral garb, they will not have and hold for a sustained period the indispensable element for practical success—public support.

We can see America's moral standing more clearly in the context of a rough catalogue of varieties of moral postures of nations. For example, there are countries where a moral resignation prevails, where immoral practices are known and condoned; accepted, not resisted. There have been civil societies, of course, where morality was almost completely destroyed, so that when severe abuses of human decency occurred, the populace was not aroused in opposition, and could not be aroused. There have even been societies in which almost the entire populace was eager to join in acts of cruelty and depravity.

But even in Nazi Germany, perhaps the worst example in history of an entire civilized nation being corrupted and enlisted in the cause of evil, the leaders seemed not to be sure of the thoroughness of popular commitment to evildoing, and so they endeavored to keep secret the mass murders in the gas ovens. And apparently they were right that many Germans, even after a decade of indoctrination, would have found it impossible not to condemn such immorality, if it had been known to them.

Thus even when we contemplate the depths of human viciousness there is reason to believe that there is in human nature a strong inclination to what is morally right—something of the angel in us—and a strong aversion to what is morally wrong. There is also reason to believe that it is very difficult, but perhaps not impossible, to eliminate in almost all of us those tendencies toward what is morally right.

There are also many societies where practices that are of a lesser order of immorality, like bribery, or tax evasion, or nepotism, or other forms of cheating, not only occur, as they do in this country, but are accepted as part of "the way things are done." Revelations of such immoral practices don't shock the people of those countries. They simply comment, "Of course. Everybody does it."

There is probably less bribery and corruption in this country than in most others, but very far from an absence of them. In this country, however, if they are exposed, they are definitely not approved or condoned. When immoral practices are discovered and publicized, the highest-ranking officials, in and out of government, will resign or will be forced out of office. However many times examples of corruption in political or business or labor or even charitable activities are exposed, we seem never to lack the moral fervor to attack and condemn, and usually to prosecute.

I will add only one more variety of national moral posture to the brief, and surely incomplete, catalogue of societies: very moral civil socieities. Some such may actually have existed for a time, and some may have existed only in fiction or utopian writings; in either case, I mean civil societies where there is no corruption, no bribery, no favoritism or self-seeking, no putting self-interest ahead of the public interest—societies that might be said to be thoroughly moral in act as well as in principle.

As I understand the Framers of our Constitution, on the evidence in *The Federalist* and in the debates of the Constitutional Convention, they looked at America and Americans and decided that it would be fruitless and impractical, and perhaps even morally wrong, for the new nation to strive to become spotlessly moral.

Liberty was their first principle and also their first goal. (Prosperity was their second goal.) A people that universally would put the public good ahead of private good every time would have to be regimented, ordered, disciplined, indoctrinated, preached to, and exhorted. Obvious institutional consequences would follow: state religion, uniform education, universal military discipline, diminution of family household influence, and curbs on commerce.[1]

The Framers knew that such a society would have to put duties first and relegate rights and everything else that is private—both low and high—to a strictly subordinate place. Self-enrichment in such a society would be scorned and replaced by concern for the moral and economic strength of the civil society as a whole. I doubt that the Framers ever gave serious thought to making a nation of men and women who would be devoid of private ambition[2]—as we are told is generally the case in present-day China, for example—but if they had given thought to it, they would have rejected it, in the name of liberty and plenty.

Their own moral concern and their awareness of the character of the American people made two things clear to the Framers: first, that political liberty and economic energy unavoidably engendered some immorality, some cheating and selfish advancement of private good at the expense of the public; second, that the American people are unrelenting moral judgers. The two basic American moral facts are that immorality is unavoidable and unacceptable.

The Framers did not seek devices or measures to prevent all immorality, but rather to control its abuses, as consistent with the American character, consistent with the principles of liberty and equality of rights, consistent with the diversity of American ethnic origins and the multiplicity of religious sects, and consistent with the entrepreneurial energy they sought to encourage.

The reader will surely have noted that several times I have spoken of American character as the Founders perceived it, as if the nation had already been formed before its founding. To a large extent I think that was the case. Consider a little simple arithmetic. If we take 1619, the date of the establishment of the Virginia House of Burgesses, the first American legislative body, as a starting point, it was 170 years later that the Constitution was ratified. That means that it was not until 1959, just a few years ago, in the lifetime of just about everyone old enough to be concerned about morality in politics, that Americans had as long a political experience on this continent since the Constitution as before it. If you have a feeling for how long ago 1789 was, you can feel how long a time the American people had to develop a character of their own before the written Constitution.

That character derived from many factors, including religion (most of the sects were dissenters); experience in self-government (the legislatures of many colonies had considerable power, including power of the purse); political doctrines emphasizing liberty and equality (from John Locke pre-eminently); and unusual, even unprecedented economic conditions.

Consider the economic conditions for a moment. Adam Smith describes tellingly, in ***The Wealth of Nations***, published in 1776, the consequences of placing cultured Europeans, especially cultured in agriculture, on a vast and fertile continent, almost uninhabited, and pretty much free for the taking. His chapter on "Causes of the Prosperity of New Colonies," begins thus: "The colony of a civilized nation which takes possession either of a waste country, or one so thinly inhabited, that the natives easily give place to the new settlers, advances more rapidly to wealth and greatness than any other human society." In seventeenth- and eighteenth-century America, labor was in short supply relative to demand. Wages were high, and conditions were favorable to the worker. It was hard to hold on to hired hands because it was so easy for them to save enough in a short time to move off to start their own enterprise, usually farming their own piece of land, and plenty of open space to move on to.

The situation was favorable for the flowering of respect for the free individual's rights, because those who were not slaves had to be treated well to keep them on the job, since they had so many opportunities everywhere. Where every hand is valuable, if you can't enslave him or her, you have to pay a high price for that person's labor. And what you pay dearly for, you value highly. But even if an employer did treat employees or indentured servants well, he was likely to lose them in a fairly short time, a few years usually, because it was so easy for newcomers with ambition to strike out on their own. In such circumstances, where the demand for labor exceeds the supply, slavery is also very attractive. If you can assure yourself of a large enough number of laborers and any way of keeping them, where naturally rich unowned land is abundant, your profit is assured. Slavery and the principles of liberty and equality that ultimately led to its destruction grew out of the same soil.

The combination of propitious economic, political, and religious factors contributed to the development of tastes, inclinations, habits, and institutions among Americans that were strong and deeply ingrained when the Constitution was written in 1787. The relevance of the pre-existing American character, in my understanding of it, can be explained by the simple device of sometimes writing the word ***constitution*** with a capital ***C***, to denote that I mean the frame of government, in our case set forth in a written document, and sometimes writing it with a small ***c***, to denote that I mean something different, which I will now try to explain.

If we speak of the American constitution—with a small ***c***—we could mean the way Americans are constituted: their character, their habits, their manners, their morals, their tastes, their countryside, their strengths, their weaknesses, their speech, their songs, their poems, their books, their sports, their machines, their arts, their heroes, their dress, their ceremonies, their homes and families, and their ways of conducting business. All of this, and more, would tell us how Americans ***are constituted.*** And since much of what is included in such a list would be the result of conscious effort and decision, it would also be possible to speak of how Americans ***have constituted themselves.*** Thus, considering how long Americans were on this continent before 1787, it is perfectly intelligible to speak of what the American constitution was before the Constitution of the United States was written, as well as to speak of the formative influence the Constitution of the United States had, subsequently, on the American constitution.

The document called the Constitution names itself in the Preamble as "this Constitution for the United States of American," but it could just as well have been called "the Articles," or "the Charter," or "the Covenant," or "the Compact," or "the Policy," or a number of other suitable words. When the Congress sent it to the original thirteen states for ratification, they gave it no caption. In most states, when it was printed for the use of the delegates of ratifying conventions and for public information, it was entitled "A Frame of Government."

The word ***constitution*** for this purpose grew in usage in the century from 1689 to 1789, from the Glorious Revolution to the adoption of the Constitution. Before that, the usage pointed more to the way things were ordered. According to the Oxford English Dictionary, ***constitution*** meant "the way in which anything is constituted or made up; the arrangement or combination of its parts or elements, as determining its nature and charcter, e.g., constitution of nature, of the world, of the universe, etc." The political usage indicated "the mode in which a state is constituted or organized, especially as to the location of the sovereign power, as a monarchical, oligarchical, or democratic constitution."

But ***Constitution*** grew out of this usage as a fitting word for a document that seeks to apply an appropriate frame of government to a people who are constituted in a discernible way. A well-designed Constitution records and proclaims how we are constituted and how we intend to be constituted for the future. Whether the Constitution is written or not, every political community has a constitution, because to be a political community it must have an accepted ordering of things and a location of the sovereign power.

Let the exception prove the rule. When we ask whether a nation ruled by a dictatorial individual or group has a Constitution, we are stretching the concept to its breaking point. For example, some nations are described as constitutional monarchies, signifying that some other monarchies are not constitutional. What we mean is that absolute monarchies have no discernible order in the ruling, that the monarch can act without restraint, without law, according to whim, not only with unlimited powers, but arbitrarily. That is why John Locke said that "absolute monarchy. . .can be no form of civil government at all."[3] And I say that any nation has a constitution, but at times there may be no Constitution and its unconstitutional rulers may not be a government.

When nations that have been ruled by tyrants overthrown them and form a new and constitutional government, it is clear that they had a constitution all along; that is, they were constituted a certain way and are now able to frame a government that is thought to suit the way they are constituted. And that "frame of government" may properly be called the Constitution. It is in this sense that we say that nations get the government they deserve.

My thesis is that the Framers considered the constitution of the American people—what they were and what they were capable of being and doing—and drew up the Constitution of the United States. They did not want to leave Americans just where they were, but, rather, starting where they were, they wanted to make them better. As was once written, long ago, by a non-American: "Lawgivers make the citizens good by training them in habits of right action—that is the aim of all lawmaking, and if it fails to do this it is a failure; this is what distinguishes a good Constitution from a bad one."[4]

The Framers did not seek to remake Americans, but rather to take them as they are and lead them to habits of right action. Their task was to direct the powerful American tendency to self-interest and self-advancement so that abuses would be controlled. More, they aimed not only to control these tendencies but actually to turn them to the benefit of the people.

Other societies have tried to curb or eliminate selfish ambition and selfish interest out of a reasonable fear that when those inclinations are combined with political power, tyranny often results and the people often lose their freedom. The constitutional scheme in other societies has relied on measures such as rigorous education in the virtues of selflessness, or constant surveillance, strict discipline, and severe punishment.

The American constitutional scheme is explained briefly in ***The Federalist.*** Put separate parts of political power in the hands of different officials in different parts of the government—legislative, executive, and judicial—and encourage, if they need encouragement, ambition and self-interest. "Ambition must be made to counteract ambition," Publius says. "The interest of the man must be connected with the constitutional rights of the place."[5] By this means the abuses of power by one official, or several, will be opposed by others who have strong and natural incentives that need no inculcation or exhortation. In fact, if officials in one part of the government should be insufficiently moved by ambition and self-interest, a necessary balancing restraint would be lacking and the danger would increase of concentration of power in the hands of others. It seems that there is a need for very many ambitious and self-interested officials to keep our government in balance. As fundamental as separation of powers is as a principle of the Constitution, that officeholders must be ambitious and self-interested is even more fundamental.

Are these the habits of right action the Constitution aims to train us in? In part, the answer is yes. In part, however, the answer must be also that the Constitution seeks to train us in habits of restraint and moderation, because that is the only way ambitious officeholders can contend with other ambitious officeholders without falling victims to the law, or to power struggles.

It is a system for nonangels who nevertheless are convinced that men and women are good enough to govern themselves. What is clear is that it is a frame of government for a people so constituted that clashing with each other almost without cease is the expected daily routing.

In a discourse on the work of Isaac Newton, Thomas Simpson of St. John's College in Sante Fe made this comparison:

> *Our Republic was designed in the image of Isaac Newton's vision of the System of the World, set forth in the Third Book of his Principia. Hobbes had taught man to regard the state as an artifice to rescue himself from war and his own nature, but it was Newton who showed how exactly-counterworking forces could be composed to form a harmonious and lasting system—and this composition of forces in the system of planets about the sun was the ultimate paradigm for the authors of our Constitution as they attempted to solve the three-body problem of the legislative, the executive, and the judicial powers.*
>
> *Newton, then, showed how the cosmos might be grasped by the mind as a purposeful system, an intelligent design; the authors of our Constitution showed the world in turn how man could make this insight, out of mathematical physics, serve him in the design of a balanced and rational policy.*[6]

I would not dare to quarrel with Dr. Simpson about Newton, but would only accept his guidance respectfully and gratefully and do my best to understand. But the notion of the Constitution of the United States as "harmonious" is very wide of the mark. Much closer, I think, is the description of Tocqueville in capturing the character of the American constitution and political system: "No sooner do you set foot on American soil than you find yourself in a sort of tumult; a confused clamor rises on every side, and a thousand voices are heard at once, each expressing some social requirements."[7] Tumult, confused clamor, a thousand voices—not harmony—that is how America was and is constituted.[8] And the Framers wisely chose, I think, not to strive to change it, but rather to institutionalize it.

If that is the American constitution, the morality most characteristic of America, then and now, is what might be called a measured, or a restrained, or a moderated, or even a mean morality. It does not ignore or condone immorality. In fact, it holds morality very high in public esteem. As I have argued, no public policy can gain and hold the support of the American people if its moral content is not laudable and apparent to the people generally. A policy may be begun, it may be continued for a time, but if it lacks moral acceptability it cannot be sustained. But the morality that is needed must commence with the understanding that men and women are not angels.

Awareness that we are not angels has complex significance. It does not mean that we are evil or unrelievedly selfish. It does mean that we acknowledge that our basic motivation is self-interest and that there is a need to control the unavoidable abuses that follow from that selfishness. From somewhere, perhaps out of our selfishness—that is, out of the sense of justice that derives from the sense of injustice (which is easily come by from the natural dislike of acts of unfairness to ourselves)—but in any case in some way there comes a strong sense of morality, of fairness, or aversion to unfairness. And this strong sense of morality leads frequently to an excess of morality.

I do not agree that measure or restraint or moderation is misplaced in matters of morality. Men and women sometimes indulge themselves in excesses of morality, and such self-indulgence and such excess have the same distorting effects as do all other forms of extremism.

The morality most appropriate to the American way, to the American constitution as it was even before the Founding, and as it still is, is a morality that is moderate, that does not crusade, that accepts the fact that among human beings who are free there will be abuses, and that does not seek to eradicate all evil from the face of the earth, knowing that such moral attempts are excessive and often lead to monstrous immorality. Though we sometimes use the rhetoric, we are not true to ourselves and to our national character when we crusade, domestically or in foreign policy.

Consider the story of Carmen. When her soldier-lover hears the bugle call summoning him back to camp, she warns him that if he goes she will not meet him again. He explains that the regulations require him to report at an appointed hour, and Carmen replies with the famous line, "Gypsy love knows no law." So it is with unbounded moralism. Alluring and seductive, it, too, knows no law. The morality of our constitution is very much a bounded and law-abiding morality.

When I speak of the American character and its morality, I do not mean that we are consistent in our tendencies and reactions. Thank goodness that we are not, and that life is not so simple and dull. The truth is, and all of us know it, that as a nation we have a multiplicity of reactions, a multiplicity of individuals and groups tending to go in a multiplicity of directions; and, sometimes, a multiplicity of tendencies contend within each of us.

One of these common tendencies is for us to shrug our shoulders when we hear one more revelation of wrongdoing. It does get tiresome, after all. We develop an aversion less to the wrongdoer and more to the moralizers and wish they would do us all a favor and just shut up.

At other times we become mightily aroused; we judge quickly and harshly; we preach to others and volunteer our services as policemen to the world, ready, like Superman, to fly anywhere in the world to fight evil, at whatever cost of pain and treasure.

Sometimes, however—and at these times we are at our best, in my estimation, and most true to our real constitution—we judge and act with measured restraint, with moderation. We do not ignore the presence of evil, nor do we try to exterminate it and, perhaps, many valuable things with it. The Constitution is designed to help foster this restraint.

Practical or political morality always involves two related but separable and distinct steps. The first step, and an essential one for a moral person, is to face the fact of wrongdoing and judge it. When we fail to take that step, we slip into our worst amoral lethargy; fortunately for us as a nation that strives for decency, failure to make a moral judgment happens rarely, and when it happens it is possible for us to be roused from it, for we are not deaf to moral suasion. So the first step is to make the moral judgment, to recognize evil as evil, and not look the other way, or refuse to judge (on relativistic grounds), or shrug our shoulders and say we "don't care."

But making a moral judgment does not settle the question of policy. The second step remains: to ask ourselves, what shall we do about it? There are moral as well as practical considerations involved in the second step. The first-step moral judgment may tell us that something ought to be done, but it leaves to deliberation what that something might be.

The best example of this I know in American history is the consistent position of Abraham Lincoln on the question of slavery. The first step was easy for him, and he made it clearly and persistently in all of his public utterances, notably in his debates with Stephen Douglas. On the question of the extension of slavery into new states and territories not yet slave territory, Douglas said "I don't care" whether it is voted up or voted down. Let the local people on the spot decide for themselves—local rule, self-determination.

Lincoln said in response what must be said first: that slavery was wrong and that we cannot say "I don't care" whether this immoral institution is extended and strengthened. After all, he argued, we are the children of the Declaration of Independence, and there are principles that will not let us alone, that we cannot turn our backs on and still remain Americans. That was the first step.

As for the second step, Lincoln said he was not an abolitionist, just as he would not be a slaveholder. Abolitionists looked on the Constitution as an abomination, a compact with the Devil, and they regularly burned a copy of the Constitution at their meetings. That is an example of the unbounded moralism I spoke of before, which in its crusading striking out at evil is likely to destroy with it many good things—like the Constitution, in this case—that give us, ultimately, our best hope for persisting decency in political life. Lincoln, unlike the abolitionists, sought a way to end slavery without destroying the Union and the Constitution, the instrumentalities of our liberties.

Thus, even after the Civil War had commenced, Lincoln was still trying to develop and get acceptance for a plan of gradual and compensated emancipation of the slaves. His plan could have taken as long as thirty-five years to complete emancipation of the last of the slaves, and no force would have been used. During that time there would be no spread of slavery, and the more it was diminished by purchase of the freedom of slaves from slaveholders, the weaker would become the pro-slavery forces.

Many would condemn a policy that would prolong enslavement for some for decades and pay slaveholders for slaves they had no moral right to own. But Lincoln thought that Americans, North and South, shared the blame for slavery and that the chief task was less to punish wrongdoers than to right the wrong. He thought some slavery could be tolerated so long as its increase was halted, its diminution assured, and its termination achieved without massive bloodshed, without confiscating what some people claimed under the law was property, without disrupting the Union, and without weakening or possibly destroying the Constitution.

Lincoln's plan for gradual compensated emancipation was not so much rejected as ignored. Instead, the Civil War went on; the matter was settled by unbounded moralists on both sides of the controversy; and we had, as a result, horrendous warfare, a divided nation, and deep-seated bitterness which, a full century later, has not fully abated.

In the light of all I have now said about how I think the Founders, or Publius, thought about this question and what the consequences are of the fact that men and women are not angelic, consider the brief passage that is the basis for what I have said, and judge my interpretation for yourself: "Ambition must be made to counteract ambition. The interest of the man must be connected with the constitutional rights of the place. It may be a reflection on human nature, that such devices should be necessary to control the abuses of government. But what is government itself but the greatest of all reflections on human nature? If men were angels, no government would be necessary."

If I am right about what kind of political morality is truly American, what kind of morality truly fits the way we have constituted ourselves as a nation, there remains still a problem of grave proportions: the question of attractiveness.

In a democratic republic such as ours, where public opinion and popular taste rule, ultimately, on everything, measures and policies must be attractive to hundreds of millions of people to gain the support that is essential to sustain them.

There is something drab and unsatisfying in moral moderation. There is a natural yearning for something higher and purer. All that aiming lower has to recommend it is that it works, but that leaves many of the best of men and women restless and dissatisfied. The search for excitment and inspiration in moderation is fruitless. For example, the only conclusion one can come to after reading the famous essay by William James, "The Moral Equivalent of War," is that there is no moral equivalent of war.

Between extremes lies a mean; it is worth pointing out that the word ***mean*** is, at the very least, ambiguous. One can try to dress it in finery and speak of the golden mean, but there just is no glitter in mean morality. Moderation or measure or restraint or seeking the mean in anything is not the kind of cause for which people devise banners and slogans. It is hard to compose a marching song or an inspirational poem in praise of sobriety or moderation. You cannot have neon borders flashing on and off, and brass bands parading, and cheering sections screaming at the top of their voices if the message is: "Be moderate." You can't even write such a command with an exclamation point without turning it into a joke.

Some words are suited for whispers or a soft voice: "Kiss me," or "I love you." Others can be shouted or screamed: "Hit him!" or "Kill the umpire!" or "Stop thief!" But moderation can be neither whispered nor shouted. To whiper "moderation" is insipid, and to shout it is rediculous. Moderation is truly a mean word.

And yet unless this notion of moderation, of bounded morality, is widely accepted, it will be hard for us to think of ourselves as a truly moral nation, for that is the morality that fits us. And that conviction, that we are truly a moral nation of moral men and moral women, is essential to our survival and happiness, because of the way we are constituted. We need to believe it; and for us to believe it, it must be true. We have for a long time been the world's best hope that political decency might prevail widely. There are still, out there in the rest of the world, billions of persons longing to be free. A revitalized America, confident of its own strength and its own rectitude, is their best hope that things might ever change for the better. A sense of our own rectitude is our Samson's long hair; without it we have no strength. I think that is what enables us to say that "right makes might," which is not to say that right ***is*** might.

What is the chief obstacle to our reviving our confidence in our national rectitude? In large part it is our powerful sense of morality and our aversion to hypocrisy. Our strong moral sense judges and condemns our weaker moral practice. Being strongly moral, we declare ourselves immoral. The judge, out of a superabundance of morality, declares the culprit immoral, but the judge and the culprit are one and the same. Is there any solution, any way for the judge to see himself as a constant moral judge as well as an inconstant immoral culprit and—on the whole—a righteous people?

I think so, and I think Publius has shown us the way. It rests on the difference between righteousness and self-righteousness. What is that difference? If we can answer that question, we can chart a course back to the national self-confidence we need, for our own sake, for the sake of political decency, and for the sake of the hopes of oppressed men and women everywhere.

Let me attempt the distinction. Because men and women are not angels, the standard of human righteousness cannot be that one act as an angel would. The standard must be something akin to our humanity, to our nonangelic state of being. For us nonangels, a righteous person is one who strives to live and act by the light of righteous principles, which include, surely, respect for the equal rights of others to life, liberty, property, and the pursuit of happiness. Trying to follow the guidance of America's standard political principles is the first element of human-scale political righteousness, whether one always succeeds or not.

We would have to add, of course, that trying is not enough in itself; there must be a fairly high degree of success. But above all there must be a recognition that because we are not angels, and because we have freedom, there will be failures, there will be fallings off, there will be abuses, and that there must be "devices" for controlling and dealing with these failures. The devices—including ambition counteracting ambition—must be bounded, and legal, and habitual, and even institutional. If we describe a people such as that—guided by right principles, usually living in accord with them, sometimes failing to measure up, rarely in doubt about what the standards ought to be, seeking to punish abuses and prevent them but too committed to liberty to seek to root out all the possible causes of future human failings—we are describing a nonangelic, but decidedly righteous, people.

Now what about self-righteousness? Self-righteousness is rightly scorned. Self-righteousness is an excess of righteousness, a distortion and disfigurement of righteousness; it is righteousness without moderation. It is more easily recognized in the flesh than defined in words. Self-righteousness is not only boring but hateful; it has been the source of many of the most vicious and inhuman acts in the annals of history, and on a grand scale.

The self-righteous person mistakes the rectitude of his principles for his own rectitude. He confounds his beliefs and his behavior. In his mind he converts his professed righteous principles into a person, and thinks he is that person. Righteousness and "self" become as one. This confusion enables him, in the name of the highest principles of morality, to consider himself the appointed enforcer of morality, the embodiment of righteousness, as if he were the Avenging Angel, or any angel rather than a human being.

Publius is our guide in this singling out and condemning the self-righteous moralist. In the simplest terms, the self-righteous person forgets the difference between human beings and angels. Self-righteousness in personal matters is distressing enough, but in government it is especially ludicrous, for "if men were angels, no government would be necessary."

Now I have finished. What I seek is some way to appeal—not through showmanship but through reasoning, which in most times and places has been attractive to young and other sound minds—some way to appeal to the best in us and persuade us that we have and always have had what is needed to be a righteous people. Nothing that has happened since we started to constitute ourselves as one people more than three hundred years ago, and nothing that has happened since we declared our founding principles and wrote down our Constitution almost two hundred years ago, has diminished the possibilities of righteousness and morality on a national scale, so long as we do not confuse righteousness and self-righteousness.

The key to our political salvation, if such combining of the secular and the divine may be allowed, is the lesson inherent in the most basic principle of the American constitution: Men and women are not angels.

FOOTNOTES

[1] Plutarch tells us how Lycurgus transformed Sparta by limiting landholdings (which brought about economic equality); by making lead the official currenty (which put an end to retail and foreign trade); and by decreeing that meals could no longer be eaten at home, but only in eating clubs (which ended the influence of mother and kitchen). These three changes reconstituted Sparta, almost at a stroke.

[2] For those who wish to ponder this subject more thoroughly, I suggest reading the discussions of salary for public officials in *The Records of the Federal Convention of 1787*, cd. Max Farrand, 4 vols. (New Haven: Yale University Press, 1911-37). See Index: salaries of congressmen, salary of executive, salary of judges. See also *The Federalist*, No. 72.

[3] John Locke, *Two Treatises of Government*, Book 2, section 90.

[4] Aristotle, *Nicomachean Ethics*, Book 2, 1103b. There is, of course, no indication in the Greek text that the word *Constitution* is capitalized.

[5] *The Federalist*, No. 51.

[6] "Newton and the Liberal Arts," *The College*, January 1976, St. John's College, Annapolis, Md.

[7] Alexis de Tocqueville, *Democracy in America* (New York: Harper & Row, 1966), p. 223.

[8] As for Dr. Simpson's contention that the Constitution is drawn out of mathematical insight, this comment of Aristotle's should suffice: "A carpenter and a geometrician both seek after a right angle, but in different ways" (*Nicomachean Ethics*, Book 1, 1098a).

DIVERSITY AND MULTIPLICITY OF INTERESTS VERSUS UNIFYING ACTION

Commentary

PIGS (Private Interests Groups) are one of the strengths of our form of government. The framers of our Constitution felt that a multiplicity of interests was needed to protect our rights. In a recent paper, Dr. Goldwin stated: "It [multiplicity] opposes the formation of an overwhelming concentration of power."[1]

The encouragement of diversity of interests has served the nation well for nearly two centuries. *A National Agenda for the Eighties*[2] points out the concerns of some citizens that the growth of diversity has exceeded the proper balance. They fear we will not build needed coalitions. They see the prolifferation of "single issue" organizations with their attendant publicity campaigns, as a threat to our form of government that must be addressed by strengthening our political parties. In this way they feel we can build the necessary coalitions and concensus needed to govern.[3]

It is important to note that even though some members of the Commission feel the prolifferation of "single issue" PIGS is not in a proper balance with unifying actions, the cure they propose does not attempt to weaken the multiplicity of interests approach.[4] Rather they seek to build a stronger mechanism to assure coalition building to act as a balance against what they see as excessive fragmentation.

Diversity and multiplicity of interests do keep the nation in at least a mild state of turmoil. But this is the path the framers of the Constitution chose to protect everyone's rights. They depended on the separation of power wtih the built-in checks and balances to achieve the unifying action needed to govern the nation. The system, although chaotic at times, has worked well.

Some people have ridiculed PIGS as being extremists, we need to remind ourselves that PIGS are beautiful.

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[1] Goldwin, Robert A., The Constitution and Human Rights, Prepared for the Editorial Services Division, U.S. International Communications Agency, March 18, 1981.

[2] A National Agenda for the Eighties, Report of the President's Commission for a National Agenda for the Eighties, Washington, D.C., 1980, pp. 10-14.

[3] *Ibid.*

[4] *Ibid.*

CONSTITUTIONAL GOVERNMENT—OF, BY AND FOR THE PEOPLE

Commentary

What implications does Constitutional government—of, by and for the people—have for the federal government in the 1980s? The response by the entire seminar group indicated some variance. Some individuals felt that the issue was not a critical one. Others felt that Dr. Robert A. Goldwin had not given any answers and no clues as to where changes should be made.

The majority, however, reacted positively, as did Group IV. These individuals felt the topic was most timely and that it merited the kind of attention that would lead to changes in government policy. Certainly the analysis is not as straightforward as some of the others discussed in the seminar. It involves a much more intensive examination of our heritage and a where-do-we-go-from-here approach.

Our group reaction was based on the in-depth study of the assigned readings. We were particularly impressed by Dr. Goldwin's article "Of Men and Angels: A Search for Morality in the Constitution" (published by the University Press of Virginia in the book entitled ***The Moral Foundations of the American Republic.***) The group found Goldwin's nonlegalistic presentation and responses to questions refreshing.

As we tried to answer the question "what relevance does this topic have for the federal government in the 1980s?" we found ourselves dealing with five different subjects: rights and duties, diversity and multiplicity of interests versus unifying actions, comparative performance of constitutional democracies and authoritarian systems, morality in the Constitution, and constitutional government and foreign policy.

CONSTITUTIONAL GOVERNMENT AND FOREIGN POLICY
Commentary

What are the implications of a Constitution of, by, and for the people in the foreign policy decision making of our federal government in the 1980s? In view of the discussions by our seminar group and the presentations by Dr. Pfaltzgraff and Dr. Goldwin, this question is one of the most crucial facing our government. Certainly the economic situation we face is important. It is one of foremost concern to our citizenry. And therein lies a reason why designing a foreign policy in accord with the Constitution is ranked with economic problems. The two are inseparable, yet the man-on-the-street rarely thinks of foreign policy.

This situation leads to a question that must be answered in the 1980s. How does the federal government arouse the public about international tensions without being an alarmist? One member of our seminar group has advocated the release of *all* satellite photography in order to give the public a clear view of the build-up of Soviet arms. This suggestion merges with Thomas A. Bailey's response to the critical symposium entitled "Can Foreign Policy Be Democratic?" Bailey reasons that the mass of people can make broad decisions if all relevant information can be placed before them, if the issues can be fully discussed, if the problems are not too technical for the lay mind, and if there is time for democratic judgments to jell. Such a theory is in direct contrast to those ideals of Sibley expressed earlier in this paper. Consequently, one implication for our federal government in the 1980s is the extensive release of foreign policy information. The big question here is, of course, how extensive.

Another implication involves space exploration. We have been assured repeatedly that our latest space effort was conducted solely for peaceful purposes. Yet we read of accusations by the Soviet Union and other Communist Bloc Nations that the space shuttle was intended to explore possibilities for space armaments. Again, with the debate between Bailey and Sibley in mind, what is the truth about our space program? Sibley would require the federal government to comply with his five points requiring full disclosure by government officials. On the other hand, Bailey's response would be that *if* certain things were done, only then could a democratic approach under the Constitution be implemented. And it is highly unlikely that the if's of Bailey are anywhere near realistic. Consequently, the implications of the pure-Constitution approach to foreign policy are idealistic, and we must look again to the morality in our Constitution.

ON RIGHTS AND DUTIES
Commentary

One problem facing our society in this decade is that of how to deal with an ever-increasing demand for the [perceived] rights of its citizens. This concept of rights, has expanded greatly since the founding of our nation through a variety of governmental policies and actions. Originating with the explicit rights enumerated in our Constitution, we have gone on to identify a new range of rights through legislative and congressional actions. The effect of these actions has been to raise our citizens' expectations of what services and facilities their government will provide or safeguard. The momentum of growth in this area has been especially great since the 1930s. The expansion of economic and social programs begun in this era and continuing through the recent past has created a host of governmental entitlement programs. One indicator of the psychology of rights is the tremendous growth we have seen in civil litigation, much of which arises from rights established through federal legislation and rulemaking.

As we begin this decade, several facts are obvious. We have recently been unable to sustain the rate of economic growth to which the citizenry has become accustomed. We are beset by foreign and domestic problems. There is an increasing dissatisfaction with governmental programs in the social services area. Many believe that the levels of regulation and taxation are becoming oppressive. A climate for change exists.

The challenge of the coming years in the area of rights will be to avoid imposing undue individual hardship or creating a climate of disaffection among large segments of our society, while at the same time revising the manner in which governmental entitlement programs are perceived. These actions will require the compromise inherent in our democratic political system and institutions.

A key ingredient in this process must be the inculcation of a sense of duty in our citizenry. The emphasis upon individual interest must be balanced by a recognition of the responsibilities of individuals to the society at large. This message must be clearly articulated by leaders at all levels and backed up by governmental policies and programs. A concept of public service should be enunciated. Where appropriate, entitlement to social programs should require some form of public service. At a different level, a formal program of national compulsory public service should be proposed, debated, and enacted. Finally, our presentation of foreign policy issues should consistently reiterate the continuing conflict between the USSR and the democratic nations of the world.

MORALITY IN THE CONSTITUTION
Commentary

Constitutional government of, by and for the people implies that our leaders be effectively under the control of the community, speak only truthfully, provide full disclosure of information for decision making by the people, provide for full discussion by the community at large, and strive to control factors that would effect irrational decisions. At least this is one philosophy put forth in the readings associated with Dr. Goldwin's presentation. If we examine those points and look at Dr. Goldwin's thesis that, since men and women are not angels, we cannot expect a true approach in a constitutional democracy, the implications for the federal government in the 1980s are clear.

Dr. Goldwin points out that the framers of the Constitution "did not seek devices or measures to prevent all immorality, but rather to control its abuses, as consistent with the American character, consistent with the principles of liberty and equality of rights, consistent with the diversity of American ethnic origins and the multiplicity of religious sects, and consistent with the entrepreneurial energy they sought to encourage." This concept, together with the philosophy set forth in the paragraph above implies that the federal government must realize that some immoral acts will occur but that they must be kept at a minimum.

Actions must be taken to ensure that our leaders can answer to the five points but with a small probablity of assassination. Quick, rational handling of such events as Abscam must set the stage so that all parties know the consequences of such actions. We must give more thought to some of the basic operating procedures to indicate to those contemplating immoral acts that these acts are not acceptable.

At the same time, actions by the federal government must attempt to strike a mean that does not either overly condemn or too easily excuse such actions unjustly. And Dr. Goldwin aptly points out that the word ***mean*** is, at very least, ambiguous. Nevertheless, therein lies the challenge and consequently the implication.

COMPARATIVE PERFORMANCE OF CONSTITUTIONAL DEMOCRACIES AND AUTHORITARIAN SYSTEMS

Commentary

Several major constitutional issues which bear upon government in the 1980s relate to both domestic economics and the international struggle with Soviet Communism. Can our system, and similar systems in other countries, continue to allow the individual rights and liberties we have enjoyed in the past while providing satisfactory economic performance and holding the line against Communism? In this era of international tension, is constitutional democracy, as a form of government, on the rise or decline?

By the end of the 1980s this country will have been governed for two centuries under a Constitution which has served us remarkably well and which has provided a model of constitutional government for many other nations. This record, unmatched by any other modern government, attests to the vigor and vitality of our system. Indeed, at different times in the past, such as the period after World War II, when many former colonies became independent nations, the prospects seemed bright for representative democracy to inspire ever-growing imitation throughout the world. But recent events have been less encouraging. Many promising democracies, such as those in Chile and South Korea, have been overturned and replaced with autocratic regimes of the left or right. This poses a dilemma in our foreign policy. Is our system one to which we should urge other peoples of markedly different cultures to aspire? Should we encourage government to follow our pattern or simply befriend nations who help us combat Soviet Communism, regardless of their own forms of government?

In the developed countries of Western Europe and in Japan, representative governments have survived and generally prospered for over three decades since World War II. A generation has matured and learned to operate and trust these institutions. But there are few countries where democratic institutions are as firmly rooted as in the U.S. and England. Threats of left and right wing takeovers seem always ready to surface, especially whenever economic conditions worsen.

Robert Goldwin seems to be cautiously optimistic about the prospects for democratic private enterprise systems compared to autocratic socialistic regimes. But he says that the democracies are "beleaguered." Until recently, their actual performance tended to be unfavorably compared with the theoretical performance of socialistic systems. He notes that enough experience has accumulated with socialistic systems that their performance can now be evaluated by both sides. The democracies fare much better in this comparison. The failures of the communist system simply cannot be excused due to forty years of bad weather!

In the decade ahead, it will be more essential than ever to understand the strengths and weaknesses of constitutional government. On the foreign policy side such understanding will be needed for winning and maintaining the support of allies and for knowing where we stand when dealing with antagonists. On the domestic side it will be needed to help judge what can be accomplished through government so that our energies can be allocated among economic, political, and social goals with minimum waste.

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From left to right: Dr. J. B. Hilmon, Associate Deputy Chief, USDA/Forest Service; James E. Haskell, Director, Cooperation Marketing, USDA/ACS; Donald Lemmon, Director, Management Policy and Systems, Office of the Assistant Secretary for Administration and Management, U.S. Department of Labor; Neill Schaller, Special Assistant for Consumer Affairs, USDA/Office of the Secretary; and Gene Mandrell, Assistant for Supply Policy (Logistics Management Specialist) U.S. Air Force.

THE U.S. IN THE WORLD ECONOMY: COMPETITIVE AGAIN

William H. Branson

I. Introduction

Since World War II, the U.S. economy grew relatively more slowly than that of Japan, Europe, and the more recently developing countries. As a result the U.S. has gone from being the dominant industrial country in the world to being one of several more-or-less equal competitors. This was only to be expected, but institutions were build at the end of World War II that did not anticipate it. As a result, the dollar became seriously over-valued in the 1960s, precipitating the crisis of 1971 and the breakdown of the Bretton Woods system by 1973.

A major economic event in the 1970s was the slowdown in the growth rate of productivity across the industrial world. It has been particularly serious in the U.S. This seems to me to be the major economic problem facing the U.S. During the period from 1950-73, the population learned to expect real product and income per capita to grow by nearly 3 percent per year. Until expectations adjust to the new reality, continued inflationary pressure will result.

During the 1970s, the dollar depreciated relative to major competitors' currencies. This greatly improved U.S. competitiveness and stabilized the U.S. share of world exports of manufactures. By 1980, the U.S. was running a large surplus in its trade in agriculture and manufactured goods, offsetting a large part of its deficit in petroleum trade. Thus the adjustment mechanism works well, if slowly, and the U.S. competitive position has been re-established.

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The outline of the paper is as follows. Section II reviews changes in the U.S. position in the world economy since 1950. The U.S. has moved from a position of dominance to a competitive position, as one of a number of industrial centers. This is viewed as a normal evolution after the disruption of the 1930s and World War II.

Section III reviews the current trade situation and the growth in interdependence between the U.S. and the developing economies. In its international trade the U.S. is increasingly an exporter of capital goods, agricultural goods, and chemical goods, and an importer of fuels, autos, and consumer goods. Through these dynamics of trade, the U.S. economy is growing in structural interdependence with the world economy.

A consistent view of the U.S. position emerges from the analysis. Many of the developing countries are borrowing from an increasingly internationalized flow of world saving (partly due to OPEC) and investing for industrial growth. They import capital goods from the U.S. with the proceeds of the borrowing and in turn sell some of the output in the U.S. This results in interdependence through the world capital markets and through the exchange of capital goods for consumer goods. This is the trend for the 1980s.

II. Broad Trends in the U.S. Position in the World Economy

At the end of World War II, the United States was the dominant industrial producer in the world. With industrial capacity destroyed or crippled in most other industrial nations, the U.S. produced approximately 60% of the world output of manufactures in 1950, and its Gross National Product (GNP) was 61% of the total of what are presently (1979) called OECD countries. This was a transitory situation. During the 1950s the European economies recovered and rebuilt capacity, ultimately competing with the U.S. in world markets. Japan entered the competition in a major way in the 1960s, and in the 1970s several developing countries became significant in terms of aggregate output and trade in manufacturers.

Since World War II, Europe, Japan and the LDCs have grown faster than the U.S. in real GDP and industrial output, both aggregate and per capita. This has resulted in a shrinking U.S. share of world output and exports and a closing of productivity differentials.

As its competitors' capacity grew faster than that of the U.S., real depreciation of the dollar was required to keep trade and current account balances in line. This depreciation was delayed by monetary arrangements under the Bretton Woods agreements, which resisted change in the dollar exchange rate.Thus, instead of a gradual real *de*preciation, a small *ap*preciation appeared in the late 1960s, contributing to a growing trade imbalance. Once the Bretton Woods system broke down, a significant real depreciation of the dollar occurred during the 1970s, helping to restore balance in trade among the industrial countries.

By 1980, the U.S. has moved from a position of dominance to a position of equality or symmetry among groups of industrial countries. It share of OECD real GNP is now 39%, and its share of world industrial production is about 35%, compared with 35% as early as 1963. The U.S. share of world exports of manufacturers has fallen from 29% in 1953 to 17% in 1963 and 13% in 1976. The weighted real exchange rate of the U.S. (in index terms, 1975 = 100) has depreciated from around 83 in 1961 to 116 in 1979.

In this section of the paper we look at comparative trends in production, then at competitiveness and trade, and finally at exchange rates. These data show the rise of competition for the U.S. and interdependence since the 1940s.

A. Measures of Trends in Output

Real GDP per Capita and per Worker—U.S. real Gross Domestic Product (GDP) and real GDP per capita have grown more slowly than those of the other major industrial countries since World War II. Table 1 shows index numbers for real GDP per capita for nine major countries: U.S., Canada, Japan, Belgium, France, W. Germany, Italy, the Netherlands and the U.K. The data are indexed to 1967 = 100. Among these countries, the U.S. and the U.K. are at the bottom in growth. The growth rate summary in Table 2A shows a general deceleration of growth in the industrial world from 1950 to 1978, with the U.S. growth rate consistently lower than the others.

TABLE 1: REAL GROSS DOMESTIC PRODUCT PER CAPITA, OWN COUNTRY PRICE WEIGHTS

(Index: 1967 = 100)

YEAR	UNITED STATES	CANADA	JAPAN	BELGIUM	FRANCE	GERMANY	ITALY	NETHER-LANDS	UNITED KINGDOM
1950	69.5	64.9	25.7	60.1	52.0	42.4	43.7	58.3	67.7
1955	78.3	73.2	37.1	69.2	61.3	63.5	56.5	70.3	77.9
1960	80.5	78.0	53.3	76.3	74.4	82.1	71.7	80.0	85.2
1965	93.9	93.7	81.8	94.5	92.3	98.8	89.2	94.8	96.4
1966	98.4	98.4	89.9	96.7	96.3	100.4	93.9	96.1	98.0
1967	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1968	103.3	104.0	112.7	103.8	103.5	105.9	105.9	105.4	103.8
1969	105.0	107.8	125.0	110.3	109.8	113.1	111.7	110.9	105.3
1970	103.6	109.1	138.2	117.2	115.1	118.7	116.8	116.9	107.4
1971	105.4	115.3	142.1	121.6	120.2	121.3	118.0	120.4	110.1
1972	110.6	120.7	153.2	127.6	126.2	124.9	120.9	123.2	112.1
1973	115.7	128.3	166.1	135.1	131.9	130.4	128.2	129.1	120.5
1974	113.3	131.0	163.4	140.8	135.3	130.9	132.3	132.7	118.7
1975	111.2	130.5	163.6	137.8	134.9	129.0	126.6	130.3	117.9
1976	116.7	136.3	172.2	144.8	141.3	136.3	133.2	136.0	122.4
1977	121.9	138.0	179.8	146.4	144.8	140.3	135.0	139.0	123.7
1978	126.2	141.6	188.6	149.9	149.4	145.0	137.9	141.4	128.1
1979	128.1	144.3	198.2	154.7	153.6	151.4	144.2	144.1	129.1

Source: Department of Labor

Tables 2B and 3 show index numbers and the growth rate summary for real GDP per employed worker, which is a measure of productivity. The U.S. growth rate in productivity is relatively slower than in GDP per capita. The productivity slowdown of the 1970s is obvious in Table 2B. Compare the rows for 1960-73 and 1973-79. Productivity growth is markedly slower in the latter period in all of the countries shown. Belgium, France, Germany, and the Netherlands show the smallest decrease. The U.S. productivity growth fell from 2.1 percent per year in the earlier period to 0.3 percent per year in 1973-79.

Tables 1 through 3, as well as the additional data on manufacturing productivity in Branson (1980), document the fact that U.S. growth in output and productivity in manufacturing since 1950 has been slower than that of the other major industrial countries. This is the case even before adjustment for the major movements in exchange rates and the terms of trade in the 1970s.

Shares of World Manufacturing Output—Calculation of shares of world manufacturing output is difficult because we have little good data for the computations. We can, however, calculate the share of a given country of the total output of a group of industrial countries known to produce perhaps 90% of the world total. Table 4 shows shares of total manufacturing output across ten major OECD countries since 1950. The method of calculation used was to convert real output by country to a common valuation using the 1967 exchange rate. The implicit assumption in this calculation is that the trend in nominal exchange rates followed relative price movements. A second way to perform the calculation would have been to use nominal output data and convert them at current exchange rates. If the assumption that exchange rates follow movements in relative prices is correct, the two calculations would be the same. But if the assumption is incorrect, the nominal cum current exchange rate calculation will distort the share data.

In Table 4 we see that the U.S. share of major industrial countries' total manufacturing output shrank from 62% in 1950 to 44% in 1977. Europe gained shares in the 1950s and 1960s, and Japan gained since 1955.

The share data of Table 4 omit manufacturing output in the developing countries, including the Southern European OECD.

TABLE 2: REAL GROSS DOMESTIC PRODUCT PER CAPITA, AND REAL GDP PER EMPLOYED PERSON [1]
OWN COUNTRY PRICE WEIGHTS
(Average Annual Percent Change)

PERIOD	UNITED STATES	CANADA	JAPAN	BELGIUM	FRANCE	GERMANY [2]	ITALY	NETHER-LANDS	UNITED KINGDOM
A. Gross Domestic Product Per Capita									
1950-79	2.1	2.8	7.3	3.3	3.8	4.5	4.2	3.2	2.2
1960-79	2.5	3.3	7.2	3.8	3.9	3.3	3.7	3.1	2.2
1960-70	2.5	3.4	10.0	4.4	4.5	3.8	5.0	3.9	2.3
1970-79	2.4	3.2	4.1	3.1	3.3	2.7	2.4	2.4	2.1
1960-73	2.8	3.9	9.1	4.5	4.5	3.6	4.6	3.7	2.7
1973-79	1.7	2.0	3.0	2.3	2.6	2.5	2.0	1.8	1.2
1976-77	4.4	1.3	4.4	1.1	2.4	3.0	1.4	2.2	1.1
1977-78	3.6	2.6	4.9	2.4	3.2	3.3	2.1	1.7	3.6
1978-79	1.5	1.9	5.1	3.2	2.8	4.4	4.6	1.9	.8
B. Gross Domestic Product Per Employed Person[3]									
1950-79	1.7	2.1	6.9	3.4	4.3	4.8	4.8	3.5	2.3
1960-79	1.5	1.9	7.1	3.7	4.2	4.0	4.6	3.6	2.4
1960-70	2.0	2.3	9.5	4.2	4.9	4.5	6.4	4.0	2.7
1970-79	1.1	1.3	4.5	3.2	3.5	3.4	2.6	3.3	2.0
1960-73	2.1	2.6	8.9	4.2	4.8	4.3	5.9	4.1	3.0
1973-79	.3	.4	3.4	2.7	2.9	3.1	1.7	2.6	1.1
1976-77	1.8	.6	4.0	1.4	2.2	2.9	1.5	2.5	.9
1977-78	.2	.2	4.6	2.5	3.5	2.4	2.2	2.2	3.2
1978-79	-.3	-1.2	4.6	3.3	2.5	3.4	3.7	2.6	.4

[1] Data for the latest year are based on preliminary estimates.
[2] Excluding the Saar and West Berlin in 1950 and 1955.
[3] Employment figures for the Netherlands are Dutch estimates of work-years of employed persons.

Note: Average annaul percentage changes are compound rates. *Source: Department of Labor*

TABLE 3: REAL GROSS DOMESTIC PRODUCT, PER EMPLOYED PERSON[1]
OWN COUNTRY PRICE WEIGHTS
(Index: 1967 = 100)

YEAR	UNITED STATES	CANADA	JAPAN	BELGIUM	FRANCE	GERMANY [2]	ITALY	NETHER-LANDS [3]	UNITED KINGDOM
1950	68.2	65.8	29.4	58.0	45.8	41.5	38.6	56.9	68.3
1955	77.7	78.0	40.5	66.8	56.0	56.9	48.6	67.8	76.1
1960	83.4	85.5	55.2	76.2	71.0	76.4	64.6	78.9	84.2
1965	96.8	98.4	83.6	93.3	91.9	94.4	87.2	92.9	94.4
1966	99.7	99.4	90.8	95.8	95.9	100.9	94.3	94.7	96.2
1967	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1968	102.2	103.7	112.0	104.4	103.4	106.3	106.9	105.4	104.8
1969	102.4	105.9	124.4	109.4	109.0	112.9	114.4	110.4	106.8
1970	101.6	107.5	137.4	114.5	114.3	118.2	120.3	116.4	109.9
1971	104.3	112.5	143.4	117.8	119.7	121.7	122.6	120.6	115.0
1972	107.4	115.7	156.5	124.2	125.8	126.5	128.9	125.9	116.9
1973	109.9	118.6	167.7	130.3	130.8	132.4	136.9	133.0	123.3
1974	106.7	117.9	167.7	134.4	134.0	135.6	139.8	137.6	121.3
1975	107.0	117.3	170.6	133.9	136.7	137.6	134.0	137.1	121.4
1976	109.7	121.5	180.0	142.1	143.1	146.2	140.7	144.6	125.6
1977	111.7	122.3	187.2	144.0	146.2	150.5	142.8	148.2	126.8
1978	112.0	122.6	195.8	147.6	151.4	154.1	145.9	151.4	130.8
1979	111.7	121.2	204.9	152.5	155.1	159.4	151.4	155.4	131.3

[1] Data for the latest year are based on preliminary estimates.
[2] Excluding the Saar and West Berlin in 1950 and 1955.
[3] Employment figures for the Netherlands are Dutch estimates of work-years of employed persons.

Source: Department of Labor

TABLE 4

SHARES OF TOTAL MANUFACTURING OUTPUT IN TEN INDUSTRIAL COUNTRIES

1950-1970

COUNTRIES	Share of Total, %						
	1950	1955	1960	1965	1970	1975	1977
U.S.	61.9	58.1	50.5	50.1	43.6	42.5	44.0
Canada	3.5	3.4	3.3	3.5	3.4	3.7	3.6
Japan	2.1	3.5	6.3	8.0	13.1	13.2	13.4
Denmark	0.7	0.5	0.6	0.6	0.7	0.7	0.7
France	7.6	7.1	8.1	8.1	8.9	9.8	9.6
Germany	10.1	14.1	17.2	16.7	17.2	16.5	16.0
Italy	2.2	2.5	3.1	3.1	3.7	4.3	4.3
Netherlands	1.8	1.9	2.2	2.1	2.3	2.3	2.2
Sweden	2.0	1.7	1.9	1.9	1.9	2.0	1.6
U.K.	8.2	7.2	6.9	5.9	5.3	4.9	4.5

Source: Department of Labor

A major development of the 1970s, however, has been growth of output in the "newly industrializing" LDCs (NICs). This has brought them into competition with the industrialized countries in markets for manufacturing, thus raising fears of a "new protectionism."

B. Trends in Competitiveness

With manufacturing capacity and output growing relatively rapidly in Europe, Japan, and the LDCs, a significant improvement in U.S. competitiveness would have been required to hold the U.S. share of world markets. During the period from 1950 to 1970, in general, U.S. costs relative to those of its competitors, adjusted for exchange rate changes, did not decline. The result was a shrinking U.S. share of world trade in manufactures. After 1970, the depreciation of the U.S. dollar improved U.S. competitiveness by about 23% (1970-79), and the U.S. share of world manufactures exports stabilized at about 13%.

Table 5 shows a measure of U.S. competitiveness—the ratio of U.S. to a trade-weighted average of 14 competitors' unit labor costs, adjusted for exchange rate changes. This is an index of cyclically-adjusted relative "normal" unit labor cost, computed by the IMF. In Table 5, we see a small improvement in the mid-1960s, which was eliminated by 1969 when the index stood at 151.2 compared with 152.6 in 1961. Then the depreciation of the dollar beginning with the German float of 1969 brought relative unit labor cost down to 100 by 1975 and to 93.0 by 1979.

C. Shares of World Trade in Manufactures

With competitors' capacity growing and no significant improvement in unit labor cost, the U.S. has lost much of its share of the world market for manufactures. Movements in the distribution of world exports of total manufactures for the period from 1953 to 1978 are shown in Table 6. The U.S. share fell from 29.4 percent in 1953 to 13.2 percent in 1976 and has been relatively constant throughout the 1970s.

During the 1950s, gains were made by Western Europe, especially Germany, the CPEs, and Japan. During the 1960s Japan's share

TABLE 5

INDEX OF U.S. WEIGHTED RELATIVE UNIT LABOR COST

1975 = 100

YEAR	RELATIVE COST INDEX
1961	152.6
1962	151.8
1963	151.0
1964	151.2
1965	148.1
1966	147.5
1967	148.1
1968	151.4
1969	151.2
1970	144.8
1971	137.0
1972	123.9
1973	110.1
1974	105.9
1975	100.0
1976	105.0
1977	103.1
1978	94.6
1979	93.0

Source: International Monetary Fund

TABLE 6: DISTRIBUTION OF EXPORTS OF MANUFACTURES (SITC 5-8)

	1953	1956	1959	1962	1965	1968	1971	1974	1976
Total Million $	37,738	51,721	61,400	79,330	109,730	150,070	226,670	483,070	585,260
Country					% of Total				
Developed[1]	88.0	83.5	82.1	81.6	82.0	83.1	83.9	83.7	83.1
LDCs[2]	7.0	6.6	5.3	5.3	5.8	5.8	5.5	7.8	8.0
CPEs[3]	5.0	9.9	12.6	13.1	12.1	11.0	10.4	8.4	8.9
Developed									
W.Europe	49.0	50.1	53.7	54.4	54.7	53.0	54.7	54.9	54.0
EEC	-	-	31.9	33.5	34.4	34.4	35.8	44.9	44.0
EFTA	-	-	20.3	19.2	18.4	17.2	17.2	8.2	8.0
Germany	9.7	12.2	15.6	14.8	15.4	14.8	15.4	16.3	15.5
U.S.	29.4	23.0	18.7	17.6	15.8	15.8	13.4	13.2	13.2
Canada	5.0	4.3	3.9	3.5	3.7	4.9	4.6	3.4	3.5
Japan	2.8	4.2	4.9	5.5	7.1	8.1	10.0	10.9	10.9
Other	1.9	2.0	1.2	0.6	0.8	1.4	1.3	1.4	1.5
LDC									
Africa[4]	1.6	1.4	1.3	1.2	1.3	1.3	0.9	0.9	0.6
Lat. Amer.	1.6	1.6	1.2	1.1	1.2	1.6	1.4	1.9	1.6
M.East	0.3	0.4	0.4	0.3	0.4	0.2	0.2	0.5	0.4
Asia[5]	3.5	3.2	2.4	2.6	2.8	2.7	2.9	4.5	5.4
NIC3[6]	0.9	0.9	0.8	0.9	1.2	1.5	1.8	2.4	3.0

[1] Developed Market Economies: U.S., Canada, Japan, West Europe, Australia, N. Zealand & South Africa.
[2] All countries excluding Developed & CPEs.
[3] East Europe, U.S.S.R., PRC, Mongolia, N.Korea, N. Vietnam.
[4] Excludes S. Africa & Rhodesia.
[5] Excludes Developed Countries & CPEs.
[6] Republic of Korea, Hong Kong, Singapore.

increased very rapidly while growth of Western Europe slowed and the CPEs actually lost market shares. In the 1970s the growth countries have been the Asian LDCs, especially the newly industrializing countries. Japan's share has continued to increase but at a much slower rate.

D. Trends in Effective Exchange Rates

The combination of growing capacity in the rest of the world relative to that of the U.S. and roughly comparable cost developments led to a significant drop in the U.S. share of world exports in manufacturing from 1950 to 1970. This in turn built pressure for a devaluation of the U.S. dollar. Under the Bretton Woods system, a dollar devaluation was effectively ruled out, so the U.S. trade balance deteriorated after reaching a peak surplus in the early 1960s. Pressure grew and the system broke down in 1970-71; the U.S. exchange rate moved to re-establish equilibrium. The ***real effective exchange rate*** was frozen during the period 1950-70, but has worked reasonably well since as an adjustment mechanism.

Table 7 shows index numbers for the U.S. nominal effective exchange rate in column (1), relative wholesale price indexes (WPIs) in column (2), and real effective exchange rates in column (3) for the period 1961-78. The period breaks clearly into two subperiods: 1961-70, in which the three series are fairly constant, and 1970-79, in which the effective rates depreciate substantially.

During the 1960s, the U.S. WPI fell slightly relative to the weighted average of those of the other industrial countries, from 102.6 in 1961 to 98.4 in 1970. This reflects the stable performance of relative unit labor cost shown above in Table 5. The effective nominal exchange rate also fell slightly during this period—an *up* valuation or appreciation of the U.S. dollar as other exchange rates moved. Consequently, there was almost no movement in the real effective rate as the U.S. lost trade shares.

Beginning in 1971, nominal bilateral rates began to move substantially, and the U.S. real effective rate began to adjust. From 1970 to 1979 the foreign exchange rate of the U.S. dollar fell and the index increased from 83.2 to 108.4, as shown in column (1) of Table 7.

TABLE 7

U.S. EFFECTIVE EXCHANGE RATES, 1961-79
1975 = 100

YEAR	(1) Effective Exchange Rate[1]	(2) U.S. WPI Relative to Competitors	(3) Real Effective Exchange Rate (3) = (1) ÷ (2) x 100
1961	85.0	102.6	82.9
1962	84.3	101.7	82.9
1963	84.2	99.7	84.4
1964	84.2	98.2	85.7
1965	84.2	98.0	85.9
1966	84.2	98.4	85.6
1967	84.0	98.7	85.1
1968	82.6	99.0	83.5
1969	82.4	99.3	83.0
1970	83.2	98.4	84.5
1971	85.5	98.3	86.9
1972	93.0	98.4	94.5
1973	101.4	98.3	103.2
1974	98.9	99.7	99.2
1975	100.0	100.0	100.0
1976	95.2	103.1	92.3
1977	96.2	100.9	95.3
1978	106.2	93.9	113.1
1979	108.4	93.0	116.6

[1] This is the inverse of an index of the weighted average of foreign exchange prices of the U.S. dollar.

Source: International Monetary Fund

From 1970 to 1974, U.S. price performance roughly matched the average of its competitors', as shown in column (2) of Table 7. From 1975 to 1977, during the recovery from the 1974-75 recession, U.S. prices rose relative to the competitors' index, but this movement was reversed in 1978-79. The movements in relative prices since 1974 have tended to make swings in the real effective rate bigger than those in the nominal rate, as a comparison of columns (1) and (3) will show.

Broadly speaking, U.S. price performance has been roughly comparable to that of its industrial competitors since 1960. During the decade 1960-70, the nominal effective U.S. rate was essentially constant (with a small upward creep due to an occasional devaluation in one of the other countries), and so was the real effective rate. With capacity growing abroad, the U.S. lost trade shares. In the 1970s movement in the nominal effective U.S. rate has brought about a real effective devaluation of nearly 40 percent, and the shrinkage of export shares has been halted. It appears that the real effective rate has worked as an instrument for adjustment and that its movements have come through movements in the nominal rate with roughly parallel price performance.

III. Structural Interdependence with the Developing Economies

During the 1970s the U.S. and the developing economies, especially those which are rapidly growing and industrializing, have developed a kind of "structural interdependence." U.S. trade reflects a trend toward increasing specialization in production of capital goods, chemicals, and agricultural products, in exchange for imports of fuel, autos, and consumer goods. These trends are documented in Branson (1980).

In its trade with developing countries, the U.S. is experiencing rapidly growing exports of capital goods and imports of consumer goods. As the developing countries industrialize, they import U.S. capital goods. In 1980 the U.S. surplus on trade in capital goods reached approximately $45 billion. In exchange, the U.S. imports final consumer goods. This interchange is an example of comparative advantage at work, making the two sets of economies structurally complementary, or interdependent. The result is increasing efficiency, in general, but if the process moves too quickly it can generate significant adjustment costs.

The composition of U.S. trade is summarized in subsection A below. Subsection B below examines the growth in capital goods exports to developing countries, and subsection C looks at U.S. consumer goods imports. Subsection D briefly discusses the implications for specialization, adjustment costs, and policy.

A. The Composition of U.S. Trade

At the end of World War II, the pattern of U.S. trade was distorted by radical reduction of industrial capacity in the other major advanced countries. Trade in consumer goods provides a good example of this distortion. In every year from 1925 to 1938 the U.S. was a net importer of consumer goods. But in 1946 the U.S. emerged from the war as a net exporter, and in 1947 the surplus on consumer goods was $1 billion. As industrial capacity was rebuilt in Europe and Japan, the surplus shrank steadily, and in 1959 the U.S. again became a net importer, with a deficit in consumer goods that has grown steadily since then. This pattern typifies what we see in the long-run data on the composition of trade. During the years since 1950 the composition of U.S. trade has moved back toward its longer-run base of comparative advantage. By the mid-1960s we see growing surpluses in trade in capital goods, chemicals, and agriculture, and deficits in consumer goods and nonagricultural industrial supplies and materials. Trade in automotive products switched from surplus to deficit in 1968.

The U.S. trade position in 1980 is summarized in Table 8. There we see U.S. trade in 1979 and in the third quarter of 1980 (annual rate) by major categories.

The surpluses in capital goods and chemicals have grown since the period just after World War II. These are clear areas of comparative advantage. The deficit on consumer goods we already have discussed; that on autos has existed since 1968. The deficit on petroleum and the agricultural surplus both became major elements around 1974.

In 1979, the $58 billion deficit on trade in petroleum was substantially offset by surpluses of $18 billion in agriculture and

TABLE 8

U.S. TRADE, 1979-80
($ billions, annual rates)

Category	1979 Exports	1979 Imports	1979 Balance	1980 III Exports	1980 III Imports	1980 III Balance
Total	185.0	211.5	-26.5	228.1	236.5	- 8.4
Agricultural	35.4	17.4	18.0	43.8	18.2	25.6
Nonagricultural	149.6	194.1	-44.5	184.3	218.3	-34.0
Nonagricultural						
Industrial supplies and materials	51.4	109.9	-58.5	62.2	121.5	-59.3
Petroleum	2.0	60.0	-58.0	2.7	69.1	-56.4
Chemicals	14.5	4.5	10.0	17.7	4.9	12.8
Capital Goods	58.2	24.6	32.9	77.6	30.0	47.6
Autos	17.4	25.6	- 8.2	16.5	28.1	-11.6
Consumer goods	12.6	30.6	-18.0	16.0	34.3	-18.3
Military	3.0	-	3.0	2.9	-	2.9
Other	7.0	3.4	3.6	9.1	4.4	4.7

Source: Survey of Current Business, 12/80

$13.5 billion in nonpetroleum manufactures, leaving a net trade deficit of $26.5 billion. In the third quarter of 1980, the petroleum deficit was $56.4 billion, but the agricultural surplus was $25.6 billion and the manufactures surplus was $22.4 billion, leaving a net deficit of $8.4 billion.

Thus, the petroleum deficit is largely offset by ***surpluses*** in agriculture and manufacturing. Within manufacturing there is a clear division by comparative advantage, with a very large and growing surplus in capital goods and smaller but significant deficits on consumer goods and autos and a surplus in chemicals.

The U.S. economy has responded to the oil price increase, which generated a $56 billion deficit by 1980, by expanding its trade surpluses along its lines of comparative advantage. The degree of adjustment is indeed quite remarkable; by 1980 we could nearly balance trade overall, with a $56 billion oil deficit. The movement in the real exchange rate helped, improving the U.S. competitive position.

B. U.S. Exports of Capital Goods to Developing Countries

A striking development in U.S. trade in the 1970s was the acceleration of growth in capital goods exports and the surplus in trade in capital goods, which reached $45 billion by 1980. During the mid-1970s, U.S. exports of capital goods to oil exporters and to industrializing developing countries made a quantum jump. [Branson (1980), p. 220] Growth in capital goods exports to these countries continues to increase and should provide an area of strength for U.S. trade in the 1980s. Rapid growth in manufacturing capacity in the developing countries is clearly good for the exercise of U.S. comparative advantage in capital goods.

Table 9 presents data on U.S. exports of capital goods, in constant 1979 dollars. We see rapid growth in spurts throughout the period since 1965. The period 1965-72 saw fairly steady growth from $13.6 billion to $24 billion (1979 dollars). Then came a jump in three years to $43.5 billion in 1975, a pause until 1977, then another jump to $57.6 billion in 1979.

The data for exports to the developing countries show differing patterns of growth since the 1970s. We see a doubling of U.S. exports to Latin America in 1972-75, a pause, and another jump in

TABLE 9: U.S. EXPORTS OF CAPITAL GOODS (TOTAL) (1979 $ MILLION)[1]

Year	U.S. Total Exports	Latin America	Near East	South Asia	S.E. Asia	Africa
1965	13600.1	2065.6			986.6	744.0
1966	15025.3	2379.2	492.0	362.8	1112.1	854.1
1967	16575.0	2533.3	615.3	271.9	1217.1	993.0
1968	17690.8	2823.8	640.1	192.3	1323.6	1055.0
1969	19165.5	2880.2	633.1	326.8	1518.1	1176.4
1970	21783.5	3262.9	883.9	325.3	1758.0	1106.9
1971	22094.9	3106.2	1009.8	260.8	2605.2	1441.4
1972	24005.8	3657.3	1269.2	177.9	3560.8	1825.4
1973	30670.9	4412.2	2060.2	374.3	3873.5	2629.3
1974	39968.6	6322.9	3686.6	410.2	4144.3	2901.5
1975	43527.9	7241.3	5113.0	394.4	4244.0	2700.9
1976	44517.4	7169.5	4717.9	410.7	4701.1	2536.2
1977	43697.2	6926.5	4841.2	462.3	6528.5	2457.0
1978	48745.3	8004.6	4401.1	670.0		
1979	57563.8	9725.4				

[1] Data were deflated using the U.S. implicit deflator for durable goods.

Source: Department of Commerce

1977-79. The major period of growth in exports to the Near East ended in 1976. The growth in South Asia has been irregular, with a surge in 1976-79. Southeast Asia resembles Latin America, with a jump in 1972-75, a pause, and another jump in 1977-79. Exports to Africa peaked in 1976. The general impression is that exports of capital goods to the Near East and Africa follow jumps in the oil price, and that exports to Latin America and South and Southeast Asia are tied to growth in manufacturing output in those areas. In 1970, exports to the developing areas shown in Table 9 were 30 percent of total capital goods exports; in 1973 this share was 32 percent, and by 1979 it was up to 41 percent.

Table 10 gives the growth rate summary for total capital goods. Let us focus on the period 1973-79. During those years, U.S. real GNP grew at an annual rate of 2.8 percent. Total capital goods exports grew at 10.4 percent. The share of LDC exports was rising over the period. As we run across the columns in Table 10 for 1973-79, we see that exports of capital goods to each developing country area except Africa grew faster than the total. Thus, in the 1970s capital goods exports grew much faster than total U.S. demand, and the share of the developing countries as a market for capital goods exports grew. Growth in manufacturing capacity in the developing countries, based significantly on international borrowing, appeared as demand for exports of capital goods in the U.S.

C. U.S. Imports of Consumer Goods from Developing Countries

U.S. imports of nonautomotive consumer goods have grown more and more rapidly in the 1970s. By 1980 the overall deficit in trade in this category was $18 billion, small in comparison to the capital goods surplus, but still significant. U.S. imports from developing countries grew from 25 percent of total nonautomotive consumer goods imports in 1970 to 50 percent in 1979. Thus as U.S. imports of consumer goods from developing countries grew in the 1970s, U.S. exports to them provided the basis for expanding these consumer goods industries. To some extent, the growth of consumer goods imports in the U.S. released resources to provide for the expansion of capital goods exports. The U.S. economy became increasingly interdependent with the economies of the developing countries.

TABLE 10: U.S. EXPORTS OF CAPITAL GOODS, TOTAL (ANNUAL AVERAGE GROWTH RATES)

Year	U.S. Total	Latin America	Near East	South Asia	S.E. Asia	Africa
1965-70	9.4	9.1	-	-	-	-
1970-75	13.8	15.9	35.2	4.5	21.5	18.2
1970-73	11.4	10.0	23.2	-20.2	22.5	10.4
1973-79	10.5	13.2	20.7	22.1	15.3	8.9
1975-79	7.0	7.4	4.4	12.3	13.0	- 1.7

Source: Table 9

TABLE 11: U.S. IMPORTS OF CONSUMER GOODS (NONFOOD, NONAUTOMOTIVE (1979 $ MILLION)[1]

Year	U.S. Total Imports	Latin America	Near East	South Asia	S.E. Asia	Africa
1965	7311.9	117.3				
1966	8351.8	140.9				
1967	8813.1	180.6	169.3	55.5	1172.1	165.2
1968	10690.3	236.8	210.7	71.8	1594.2	172.8
1969	12439.6	285.4	222.8	78.2	2088.8	164.9
1970	13795.0	372.3	208.6	78.2	2590.4	145.2
1971	15145.4	457.8	230.7	84.7	3046.3	220.4
1972	19416.2	685.0	308.3	129.8	4237.7	248.6
1973	20810.9	1033.0	368.1	165.3	5065.3	308.2
1974	20374.2	1565.3	318.2	222.7	5124.7	246.8
1975	17620.4	1186.4	304.6	276.5	4881.7	565.4
1976	22860.8	1401.3	384.3	336.3	7629.0	560.3
1977	26498.3	1558.1	493.1	398.4	8864.7	731.9
1978	31153.9	1758.5	594.2	631.6	10846.7	779.9
1979	30269.3	1868.6	528.3	588.4	10877.4	1136.3

[1] Data are deflated using GNP implicit price deflator for nondurable goods.

Source: Department of Commerce

Table 11 presents the data in U.S. imports of nonautomotive consumer goods in constant 1979 dollars. We see fairly steady growth in total imports of nonautomotive consumer goods except during the recession year of 1975 and the growth recession that began in 1979. In the data for imports from Latin America we see a quadrupling from 1970 through 1974, a drop in 1975 and more gradual growth since. Imports from the Near East and South Asia show steadier growth paths, with South Asia the steeper. Imports from Southeast Asia doubled from 1970 to 1974, paused in 1975, and then doubled again by 1979. Imports from Africa increased fivefold from 1970 through 1979 The share of the LDCs in total U.S. imports of nonautomotive consumer goods ran from 25 percent in 1970 to 33 percent in 1973 and 50 percent in 1979. Their total of $15 billion in 1979 was much less than U.S. exports of capital goods to them—$24 billion in 1979.

The growth rate summary of Table 12 shows U.S. total imports of nonautomotive consumer goods growing at an annual rate of 6.2 percent from 1973 through 1979, again faster than total real demand. Imports from each developing country area grew substantially faster, as their share increased. Thus, as manufacturing capacity grew in the developing countries in the 1970s, their output found a market in the U.S.

D. Summary and Questions for Policy

In its trade with developing countries in the 1970s, the U.S. has become increasingly complementary and specialized. The overall composition of U.S. trade has moved increasingly toward export surpluses in capital goods, agricultural goods, and chemicals, with deficits in autos, consumer goods, and fuels. By 1980, the U.S. had surpluses on manufactured goods and agriculture of $30 billion.

In its trade with the developing countries, the U.S. is increasingly an exporter of capital goods and an importer of consumer goods, with a surplus on this exchange of about $9 billion in 1979. This fits well with basic notions of comparative advantage, and it reflects an efficient reallocation of resources in the U.S.

This increase in structural interdependence with the developing countries fits into the picture of borrowing and growth in the de-

TABLE 12: IMPORTS OF CONSUMER GOODS (NONFOOD, NONAUTOMOTIVE)
(ANNUAL AVERAGE GROWTH RATE)

Year	U.S. Total	South America	Near East	South Asia	S.E. Asia	Africa
1965-70	12.7	23.1	-	-	-	-
1970-75	4.9	23.2	7.6	25.3	12.7	27.2
1970-73	13.7	34.0	18.9	24.9	23.4	25.1
1973-79	6.2	9.9	6.0	21.2	12.7	21.7
1975-79	13.5	11.4	13.8	18.9	20.0	17.4

Source: Table 11

veloping countries. As the industrializing developing countries borrow internationally to finance growth, they buy capital goods from the U.S. In turn their manufactured consumer goods find a market in the U.S. The picture of interdependence through capital markets and through industrial structure is consistent and probably efficient in the long run.

The rapidity of change in the structure of trade, however, raises difficult problems of adjustment in the U.S. The reallocation of resources is efficient in the long run, but it imposes adjustment costs in the short run. If the long run efficiency gain is to be realized, some of it should be redistributed to the short run losers through an effective program of adjustment assistance. This would make the resulting interdependence socially efficient, as well as politically easier.

IMPLICATIONS FOR THE FUTURE
Commentary

The 1981 version of the seminar on "Critical Issues and Decisions for Government Executives" focused on four specific areas: the domestic economy, foreign policy, Constiutional government, and the role of the U.S. in the international economic situation of the future.

In seminar discussions, the lines between the subject areas were often crossed. Indeed, that is the first conclusion we reach: that these subjects are inextricably interrelated. The future is not really a separate topic, but a critical dimension of every issue examined in this seminar.

There was considerable discussion of whether it is worthwhile to attempt to think about the future, beyond the two- to three-year planning agenda of most elected and appointed federal officials. We reach the conclusion that it is essential to attempt to look further ahead than that.

Prediction of future events or trends is an inexact process, to say the least. But medium-term projection, periodically updated, provides a helpful perspective in which two- to three-year policy, program, and budget planning can be better done. In addition, we believe that identifying emerging issues of potentially national importance requires a disciplined effort to look from ten to twenty years ahead.

A most fundamental question facing all of us on concerns for foreign policy and defense is this: "Will we be alive in a United States that is essentially the same political and economic entity it is today?"

We believe that the military power and capability of the USSR ***has*** increased rapidly in relation to that of the U.S. Whether it now exceeds, or will soon exceed, that of the U.S. may not really be pertinent. If the Soviet leaders ***perceive*** a sufficient advantage, that may be enough to cause further, even more aggressive moves, in areas we consider vital to our security (e.g., the Middle East) or against the U.S. itself.

After some years of experience as federal government executives, we are well aware that simply appropriating more money for "defense" will not necessarily result in a leaner, tougher, more capable armed force. The U.S. cannot afford to go through another period in which we permit our military capabilities, relative to the USSR and its client states, to deteriorate significantly. Let us rather increase our defense capability, shore up our existing alliances, and make new alliances.

Since most economists appear unable to explain our present domestic economic situation, we seriously question the wisdom of attempting to "manage" various aspects of the economy when we really cannot account for what has happened under the "management" of our economy today. Therefore, we believe that, in general, much less emphasis should be placed on fine-tuning the economy by the federal government.

We do not advocate the "growth at all costs" policy. Nevertheless, in our opinion, a policy of planning based on the expectation of growth in the economy is necessary. We recognize that growth rates will vary over a period of time and that in the future our maximum growth rates may not be as high as they have been in the past.

The recommendation of the Commission on "National Agenda for the 80's—that the federal government act to achieve greater price stability—is hard to oppose in principle. It is what the whole thing is about! But we think that the proper environment to achieve these ends calls for substantially less federal government action, not more. We also strongly endorse this panel's recommendation that "governments at all levels should make greater efforts to improve their own productivity."

Dr. William H. Branson emphasized the macroeconomics of interdependence between the U.S. and the developing countries in the future, and he attempted to place in perspective the "bad" international trade position of the U.S. today. His view is that the U.S. share of the market and our relative influence in world trade is only now returning to a more normal level. It is a mistake to expect continuation of the almost absolute dominance of the U.S. in the late 1940s and the 1950s, which was due to the destruction of much of the productive capacity of the industrialized nations. Therefore, we agree that it would be impossible for the U.S. to retain the level of dominance it once had and that our percent of the world market today may be close to that which we can normally expect.

Coincident with the slowdown in economic growth in the U.S., as Dr. Branson points out, is a worldwide slowdown in the growth of economies. He states that the rate of productivity in the world, generally, has fallen by one-half and nobody knows why. There are some statistical data that suggest this is the result of cyclical factors and that approximately every 50 years (again for reasons no one can determine) productivity rates decline generally.

Dr. Branson's conclusion that the U.S. economy in the futrue will be much more interdependent with the economies of the developing countries seems reasonable and acceptable. He states that U.S. industry today is much more competitive in the world market than it was in 1971, but with a special difference. Market, and other forces, are pushing the U.S. more and more into product specialization. He produced data to support his contention that the U.S. export of capital goods is growing faster than our Gross National Product. He also convincingly shows that much of this export of capital goods is going to developing countries from whom we import consumer goods and who borrow from OPEC countries to make up the deficit, if necessary.

As product specialization in the world market proceeds, the U.S. will inevitably become more vulnerable to the cutoff of trade from other nations from which we buy specialized products or raw materials. From a strictly economic point of view, we agree that it is efficient for countries to specialize in what they produce best and to permit the market to freely determine that factor. However, for national defense reasons, we cannot permit particular industries (e.g., the auto or ship building industries) to deteriorate completely or to the point where they could not supply minimum defense needs if the supply of such equipment is cut off from other sources.

The process of "specialization" in production and marketing is a natural and "efficient" response to free market operations. It is politically unfeasible to permit it to operate totally. This is true not only from a national defense view. Major social dislocations may occur as the result of industries, or major portions of them, dying. We do not believe that any significant changes can come about in the economy of the nation without social cost to somebody. How that cost and dislocation can be cushioned is a legitimate concern of the federal government, provided it is understood that it is not possible to protect every individual from the effects of such dislocations.

In the ***Federalist Papers,*** James Madison (writing as "Publius") explicitly stated that the Constitution was conceived as the basis for government by human beings—not angels. He and the other framers of the Constitution concerned themselves with structuring a government which would work in the presence of a great multiplicity of interests, opinions and religious sects, in a way that would make it difficult for such groups to combine into an oppressive majority ***that could be sustained.*** The amendment process is one of the safeguards against major changes in our basic structure of government by "oppressive majorities," which hold together for a relatively short time.

Dr. Goldwin also makes a persuasive case that very few, if any, specific "rights" should be defined or guaranteed in writing in a Constitution, because every such explicit "right" requires the government to intrude into the private lives of citizens to assure it. He further concludes that "what really secures the rights of individuals is the denial of power to government." (The Constitution of the USSR is offered as an example of an extensive list of "parchment rights" which provides the government legal sanction to reach into "the totality of human activity" of its citizens.)

Probably in every decade of our nation's history, some set of circumstances has caused substantial pressure for changes in our Constitution out of frustration over the slowness with which our representative democracy works (which is one of the chief safeguards of individual liberty and rights) or because of some "clear and present danger.'' Time has, in most such instances, provided that the basic structure was sound for the long run.

We accept the view that the Constitution does not rely on virtue in public servants, or the general public, to work. Americans should continue to recognize and loathe immorality, wherever it appears. But this does not mean advocating the kind of moral extremism which would pronounce anathema upon every person or government that does not meet our collective standard of morality. We can eject from office, and otherwise punish, our own citizens for illegal or immoral acts; other nations present a different problem.

A a practical matter, we should neither ignore such conduct (which might prolong it) or take the extremist position and sever relations, cease economic or military aid, take sanctions, or, finally, go to war because of it. We should usually follow a middle course, sensitive to our long-term ''vital interests,'' while working to ameliorate the problem without taking extreme positions that in the long-run would endanger the liberty and human rights of Americans.

In conclusion, we face the future of the United States with considerable concern because of the magnitude, complexity, and stubbornness of the domestic and international problems before us and their potential impact on us as government employees, and on our families. Yet we face that future with more optimism than in the recent past.

We cannot know whether the combination of actions and policies called ''supply-side economics'' will work effectively. We lack knowledge and facts to fully endorse the economic policy prescription offered. We feel the government should presently be considering ''second-best'' alternatives in case these economic policies fail to work.

We recognize that Administration spokespersons are unlikely to talk about alternatives, in case their solutions to our economic problems does not work adequately, at least not while they are trying to get it through the Congress. But we preseume that ***somebody*** in the Administration must prepare for contingency action if results fall far below expectations. That would not be disloyal; it would be judicious and responsible.

The nation is in an up-beat mood, which may well provide the unmeasurable, unaccountable something extra (of which economists seem so skeptical) that will return to us a sense of well-being and pride.

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